RECENT DEVELOPMENTS OF MERCHANT

BANKING ACTIVITIES IN HONG KONG

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RESEARCH REPORT

presented to

The Graduate School

In Partial Fulfilment

of the Requirements for the Degree of

MASTER OF BUSINESS ADMINISTRATION

TWO-YEAR MBA PROGRAMME

THE CHINESE UNIVERSITY OF HONG KONG

May 1985

John L. Espy

PROFESSOR JOHN L. ESPY

Advisor

ACKNOWLEDGEMENTS

We would like to take this opportunity to express our deepest gratitude to Professor John L. Espy for his invaluable support and supervision.

We also wish to acknowledge Miss Peggy Yeung for giving us valuable suggestions in the research project and arranging pilot interviews for us.

Furthermore, we are greatly indebted to the following bankers for their insightful opinions on the subject during the interviews:

BA Asia Limited
Mr. Ken M. Loh

Chase Manhattan Asia Limited
Ms. Sarah Chan
Mr. Terry Tse
Ms. Peggy Yeung

Morgan Guaranty Limited
Mr. Lionel Kwok
Ms. Felicia Wai

Schroders Asia Limited
Mr. Hugh W. Bolland

Wardley Limited
Mr. Vincent Ng

ABSTRACT

Syndicated lending activities has been growing in the international capital market for more than a decade. However, after the outbreak of the debt crisis in 1982, merchant bankers become more aware of the significance of liquidity and security of their money.

Starting from 1982 in the Eurocredit market and 1983 in the Asia- Pacific lending market, the volume of syndicated loan have been shrinking. In 1984, the volume was only one-half that of the peak in 1981. Although the total funds raised via loans, bonds and notes are also slightly decreasing from the early 1980's, the security market, especially the floating rate notes (FRNs) experienced a significant upturn. 'Packing' of the FRNs, in order to make them more price competitive, provide more options to investors, enhance tradeability and look more fresh, is the name of the game.

Another popular financial vehicle involved recently is the swap. Due to the volatile interest rate and exchange rate fluctuations, large corporations and banks minimize their exposure and risks by means of swapping their assets and liabilities.

Hong Kong, being the third largest financial centre, is in a

favourable position to tap the pioneer innovative instruments and to apply in our market. Following the global merchant banking market trend, bankers, investors, and financial management of large corporations in Hong Kong are learning and progressively accepting these new ways of survival.

TABLE OF CONTENTS

LIST OF ILLUSTRATIONS

LIST OF TABLES

CHAPTER 1

SCOPE OF STUDY AND METHODOLOGY

1.1 Scope of Study

This is a study of the current development of merchant banking activities in Hong Kong with special reference to the growing importance of floating-rate notes and swaps. In this study the term 'bank' will be used to include merchant banks, deposit taking companies, finance companies, and all other financial institutions engaged in merchant banking activities such as syndicated loans, securities underwriting, bonds and notes trading, corporate finance services etc.

The study will focus primarily on the activities between the period of 1980 to early 1985, with special attention on the last two years.

The study is not limited to those merchant banking activities managed and concluded in Hong Kong. The general trend in terms of trading volume, and innovative financial facilities in the Euro market and the Asia-Pacific market will also be discussed.

1.2 Methodology

The following methods were used to collect information about the current development of the financial markets and the innovative financial vehicles in the merchant banking arena.

1. Sorted out and analyzed syndicated loans signed, bonds and notes floated, and floating-rate notes issued in the Euromarket from 1979 to 1984, using Euromoney as the primary source.

2. Sorted out and analyzed syndicated loans signed from 1979 to 1984; bonds and floating-rate notes issued in the Asia-Pacific Region for 1983 1983 and 1984, using Asian Finance as the primary source.

3. Studied relevant articles in books, journals, magazines and newspapers listed in the bibliography.

4. Carried out six formal and indepth interviews with responsible personnel in international and local merchant banks active in the lending and underwriting business in the region in order to present a clear picture of the followings:

   i) The global and Asia-Pacific trends of the capital market, especially with respect to the advantages and disadvantages of syndicated loans, bonds and notes, and other innovative financial instruments, including swaps.

ii) The classification and market segmentation of merchant banks in Hong Kong.

iii) The innovative arrangements managed by Hong Kong merchant banks.

1.3 Research Limitations

There is a great difficulty in obtaining complete figures for the bonds and floating-rate notes issued before 1981 in the Asia-Pacific region because the statistics published did not differentiate between the two.

Many of the innovative deals and fresh financial instruments were started, arranged, and concluded in the Euro market where the volume and sohpistication are more prominent than in Hong Kong. The current development of merchant banking activities in Hong Kong or the Asia- Pacific is more or less the follower of the Euromarket rather than the innovator. Therefore, part of the study will stress on the significance of the Eurocredit and Euronote markets.

As far as those 'sensitive businesses' such as swaps, private placements or additions of 'innovative ingredients' into the existing popular financial vehicles are concerned, bankers were reluctant to disclose any particular details except those mechanical operations and global views during the interviews.

We regret that we could not we cannot arrange interviews with the users of the new financial vehicles in Hong Kong in order to collect their first hand views about current developments in the merchant banking field.

CHAPTER 2

MERCHANT BANKING ACTIVITIES IN HONG KONG

A merchant bank in Hong Kong operates both on a local and international basis. It provides medium to long-term finance for companies and operates in the world capital market. It advises companies on the raising of capital or on acquisitions, and also provides professional management of investment portfolios. A commercial bank acts as both a wholesaler and retailer serving both large and small clients. A merchant bank, on the other hand, is a wholesaler and only deals with a few customers who wish to borrow large sums of money. A merchant bank in Hong Kong is not allowed to engage in commercial banking activities. The activities of a merchant bank may be classified in different ways, and in this research they are classified under four main categories.

2.1 Corporate Finance

Merchant banks act as financial consultants of major corporate clients and give them the appropriate advice on the present corporate financial structure and future expansion by equity management through flotation or rights issue, by issuing debt instruments, or by project financing. They also advise on the restructuring of companies in the form of merger and acquisition or reorganisation.

2.1.1 Flotations

When a company wants to expand its operation, it can raise capital by flotation. Merchant banks will advise these companies how to go public and to obtain a stock exchange listing. They will also act as underwriters and give expert advice on public flotation concerning the financial, legal, accounting and stock exchange aspects, especially on the timing and pricing of the stock issue.

2.1.2 Rights Issue

Merchant banks can underwrite and advise on the timing and pricing of the rights issue of a listed company when it needs to raise further capital for expansion or other purposes.

2.1.3 Project Financing and Development Financing

Some companies cannot easily obtain financing from commercial banks and they thus have to get financial support from the merchant banks. Merchant banks can help these companies to analyse the different cash flow requirements at various stages during the project development, and thus advise on their balance sheet structure, and help them to finance and manage other financial matters.

2.1.4 Mergers and Acquisitions

Mergers and acquisitions are often employed to accelerate the growth of a company, in order to expand a company's market share, for vertical integration, or to diversify its operations. Merchant banks sometimes initiate the arrangement by identifying the opportunities and bringing together the companies with common interests. The merchant banks advise on complex issues relating to the legal, accounting, and stock exchange (if the companies are listed) considerations and to coordinate all these activities. Advice will then be given on the most suitable source of finance by equity, borrowing or issuing debt instruments. In case of takeovers, merchant banks may advise the acquiring companies or defend the companies to be acquired against unwelcome approaches.

2.2 Capital Markets

A company can raise capital at low cost in a well-established capital market to finance their long-term investments. A capital market differs from a money market in that the maturity in the former is usually medium to long-term, while in the latter it is short-term. The various instruments available in the Hong Kong capital market includes common stocks, warrants, bonds, commercial paper, floating rate notes, and floating rate certificates of deposit. The debt instruments can either be denominated in Hong Kong dollars or in other currencies, usually US dollars. These debt instruments have grown in popularity during the recent years and their structures are becoming more complex. Merchant banks act as professional advisors to the client companies or sometimes even as underwriters.

A major function of the local merchant banks is to underwrite the issue of common stocks to raise capital for the client companies. The merchant bank buys the whole issue from the company at the issue price less the commission. Then the merchant bank offers the issue for public sale. Between the time the merchant bank pays the company and the time the issue is sold, the merchant bank bears the risk of market price fluctuations and the risk of under-subscription after the issue. Merchant banks act as middlemen and distribute the issues more efficiently and more economically than individual corporations.

2.3 Funds Management

Merchant banks provide a complete management service for different types of investors with different approaches. The usual types of funds managed include unit and investment trusts, and pension and provident funds.

2.3.1 Unit Trusts and Investment Trusts

Investment companies sell their own stocks to the public and invest in stocks and bonds of other companies. These investment companies can be divided into the open-end and the close-end companies. The open-end companies have no fixed capitalization and their funds are known as unit trusts. The closed-end companies, whose shares are available on the stock exchanges, have a fixed capitalization, and their funds are known as investment trusts. Most of the unit trusts are managed by merchant banks and other investment management companies while most of the investment trusts are managed by the investment companies themselves. Unit trusts are becoming more important in Asia and some merchant banks have sponsored unit trusts and investment trusts under their own management.

2.3.2 Pension Funds and Provident Funds

Most of the pension funds and provident funds managed by merchant banks are from large Hong Kong companies. Usually the funds are invested in long-term government bonds or fixed-interest paper denominated in Hong Kong dollars. However, these instruments are rare in Hong Kong and hence most of the funds are invested in the Hong Kong stock market, the Eurocurrencies market of the Eurobond market.

2.4 Lending

The merchant banks in Hong Kong offer a spectrum of loan facilities, ranging from short, medium (up to 7 years) to long (over 7 years) term loans, and can be in either Hong Kong Dollar or other currencies. Of all the loan facilities, the syndicated loan is the major source of income and the major function of the merchant banks. Withan excellent communication and transportation network, laissez-faire policy, low tax-rate and good support services, Hong Kong has been the regional centre for loan syndication of South-East Asia. The large loans have to be syndicated among many participating banks to spread the risk and also no single merchant bank can afford such a large amount. Because of the lack of a local deposit currency base in the Asian countries, most foreign merchant banks denominate the syndicated loans in US Dollars with an interest spread over LIBOR, HIBOR or SIBOR.

2.5 Other Activities

Many merchant banks also provide other financial advisory service on tax-related financial alternatives, and the effective use of interest-rate and currency swaps to reduce financial risks.

Still other merchant banks are involved in foreign exchange dealings, gold trading, insurance underwriting, money changing, bill financing and some other minor activities.

CHAPTER 3

RECENT TRENDS OF MERCHANT BANK ACTIVITIES

3.1 The Rising and Falling Stars

The syndicated loan has always been viewed as a superstar in the capital market and the mainstay of merchant banking activities for the last twenty years. But when entering the 1980's, its supreme position seems facing a lot of challenges. Figures in Table 1 and Table 2 on the next pages show the volumes and various ratios respectively for syndicated loans, all bonds and notes and floating-rate notes from the period 1979 to 1984 in the global market.

As seen from Table 1, the volumes of syndicated loans are declining during the last five years except the rebound in 1981. The total amount of funds raised each year by all means is however in the increasing trend. The volume decreased from US$ 175 billion in 1981 to US$ 90.8 billion in 1984 while bonds and notes grew from US$ 27 billion in 1981 to US$ 79 billion in 1984. Although the funds raised through the syndicated loan market and bonds and notes market were fluctuating between US$ 150 billion to US$ 200 billion, the proportion of funds raised through the loan market are obviously diminishing. The share of the loan market is taken over by the bonds and notes markets cited from the declining percentages each year and the ratio between the volume raised through syndicated loans and bonds and notes markets in Table 2.

TABLE 1

VOLUMES OF SYNDICATED LOANS, ALL BONDS AND NOTES (INCLUDING FRN) AND FRN SIGNED AND UNDERWRITTEN IN THE GLOBAL GLOBAL MARKET, 1979-84

YEAR	SYNDICATED LOAN US$ Billion	BONDS & NOTES US$ Billion	TOTAL US$ bn	FLOATING-RATE NOTE US$ Billion
1979	102.5	14.527	117.0	4.023
1980	88.0	18.614	106.6	4.118
1981	175.0	27.713	202.7	8.000
1982	146.8	47.280	194.1	12.000
1983	99.3	47.229	146.5	14.949
1984	90.8	79.342	170.1	31.644

Source: From Euromoney, February issues from 1979 to 1985.

estimated figures

TABLE 2

VARIOUS RATIOS FOR SYNDICATED LOAN, BONDS AND NOTES, AND FRN VOLUMES

YEAR	% CHANGED OVER PREVIOUS YR			RATIO BETWEEN	% OF FRN IN
	Syn. loan	Bonds & Notes	FRN	Loan : B & N	Bonds & Notes
1979		20.4 %	75.7 %	7.1 : 1	28 %
1980	141.0 %	28.1 %	2.3 %	4.7 : 1	22 %
1981	99.0 %	48.9 %	94.3 %	6.3 : 1	29 %
1982	16.1 %	70.6 %	50.0 %	3.1 : 1	25 %
1983	32.4 %	0.1 %	24.6 %	2.1 : 1	32 %
1984	8.6 %	68.0 %	110.7 %	1.1 : 1	40 %

Source: Compiled from Euromoney, February issues from 1979 to 1985.

3.1.2 The Asia-Pacific Trend

The size of the Asia-Pacific syndicated loan market comprises roughly one sixth to one-seventh of the world market. Volumes of syndicated loans, bonds and FRN are shown on Table 3 overleaf.

The syndicated loan market in the Asia-Pacific started to experience shrinkage only after 1983 compared with the Euro market in 1982. The Asian market still managed to climb in 1981 and 1982 following the rising trend in the Euro market in 1981. The volumes of loans syndicated were US$ 18 billion in 1981 and US$ 27 billion in 1982 compared with only US$ 13 billion in 1980.

However, the volume suddenly dropped to US$ 15 billion in 1983 and then levelled in 1984 from the peak in 1982, representing a 43 % decline. Following the trend in the Euro credit market, the bonds and notes issues started to mushroom in 1983, replacing the star performance of syndicated loans. And the proportion of syndicated loans in the capital market were also lessening: 55 % in 1983 and 48 % in 1984, with actually no growth in volume.

TABLE 3

VOLUME AND PERCENTAGE CHANGED OF SYNDICATED LOANS (1979-84), ce BONDS AND FRN (1983-84) IN ASIA-PACIFIC

YEAR	SYNDICATED LOANS		BONDS		FRN	
	US$ Billion	% Changed	US$ Bn.	% Changed	US$ Bn.	% Changed
1979	19.948	72.0 %	--	--	--	--
1980	12.872	35.5 %	--	--	--	--
1981	18.497	43.7 %	--	--	--	--
1982	27.539	48.9 %	--	--	2.025	--
1983	15.582	43.4 %	10.347	--	2.236	10.4 %
1984	15.620	0.2 %	13.246	30 %	3.291	47.2 %

Source: From Asian Finace, January issues from 1980 to 1985.

TABLE 4

PROPORTION OF SYNDICATED LOANS, FRN AND BONDS

IN ASIA-PACIFIC, 1983-84

	1983	1984
Total amount raised US$ Bn.	28.165	32.157
% raised via syn. loan	55.3 %	48.6 %
% raised via FRN	7.9 %	10.2 %
% raised via bonds	36.7 %	41.2 %
	99.9 %*	100.0 %

Source: Compiled from Table 3 A.

*due to rounding

Table 5 shows the break down of the Asia-Pacific FRNs in 1984 amd 1984 regarding volume, number of deals and borrowers' countries.

TABLE 5

ASIA-PACIFIC FRNs IN 1983 AND 1984

	1984		1983	
Country	Total Volume (US$ Million)	No. of deals	Total Volume (US$ Million)	No. of deals
Japan	1,225	12	350	3
Malaysia	950	2	500	1
Australia	401	1	586	3
South Korea	346	5	150	3
HONG KONG	139	2	--	-
Thailand	135	2	60	1
New Zealand	95	1	300	1
Indonesia	--	-	250	1
Taiwan	--	-	40	1
TOTAL	3,291	25	2,236	14

Source: From Asian Finance, January 1985.

Japanese banks were the biggest issuers because they are required to match a proportion of their lending with long-term liabilities. Malaysia raised US$ 950 million, including a US$ 600 million issue, its biggest single borrowing in 1984. South Korea is also attracted to the FRN market, and rasied an equivalent of US$ 346 million. In fact, the 75 million offering by the state-owned Korea Exchange Bank was raised to 125 million later because of strong demand. The details of this issue is shown in Appendix 1. The issues for the corporation in Hong Kong will be discussed later in the study.

3.1.3 The Floating Rate Notes (FRNs) Market

Without doubt the floating-rate note was the year's star performer in 1984. In fact, every sector of the Eurobond and Asian bond markets registered a great increase in 1984, 68 % in the Eurobond market, 31 % in the Asian bond market. Fixed-rate, floating-rate and convertible sectors gained significanctly and more money was raised than 1983 when US$ 47.2 billion and US$ 12.6 billion worth of bonds and notes were launched in the Euro and Asian markets respectively.

Among the sectors, the FRNs was the most outstanding one. FRNs has growing from 1973 with issues of only US$ 40 million in the Euromarket to US$ 31.6 billion in 1984, amounting to a 110.7 % increase over the US$ 15 billion total for the whole in 1983. By comparison, fixed-rate issues were 'only' one-third up over the 1983 total of US$ 30.5 billion. The proportion of FRNs in the

Euro bonds and notes market were also becoming more significant, soaring from 22 % in 1980 to 40 % in 1984.

Returning to our Asia-Pacific bonds and notes market, growth of FRN in 1984 also outshone all other sectors and jumped 47 % to US$ 3.3 billion over 1983's figure US$ 2.2 billion. The first Hong Kong FRN issue was in September 1984 by Mass Transit Railway Corporation amounting HK$ 500 million. An analysis of the growing popularity of floating-rate notes will be discussed in section 3.2.

3.1.4 The Swap Market

Another rising star performer in the capital market is swap. Unlike FRNs having quantitative statistics to show its booming trend, the swap market is somewhat like a star behind the stage. Without any reliable statistics on the overall size of the swap market, bankers estimated the market to be between US$ 14 billion to 20 billion in 1983 and the growth rate is high.

The Asian swap market is still an unexplored mechanism comparing with other financial techniques. Asia has been slow in adopting or using the swap mechanism and whose aceptance so far has been limited; this is partly due to their conservative culture. However, the use of swaps in a greater scale in the future should be optimistic, according to many local bankers.

3.2 Reasons for the General Trend Toward Securitization

From the league table analysis in the last section, the syndicated loan volume in the international market dropped from US$ 99.3 b in 1983 to US$ 90.8 b in 1984 (decrease of 8.6%), while the FRN issued rose from US$ 15.0 b in 1983 to US$ 31.6b in 1984 (increase of 110.7%). This reversing growth trend of syndicated loan and FRN has been prevailing since 1981 in all the major capital markets including Europe, America and Asia. This trend can be analysed from three aspects: the banks, borrowers, and the investors.

The global debt crisis and the consequent bad loans have had a tremendous impact on the banks' lending activities. Firstly, the banks become more prudent in lending and they have more confidence on the sovereign borrowers and reputable corporations instead of the smaller borrowers. Also, the underwriting of FRN, as explained later, imposes reduced risk to the banks than underwriting the syndicated loans. Thirdly, the bearer nature of FRN ensures that it can be traded in the secondary market, and thus has higher liquidity to the bank than syndicated loans. Besides the debt crisis phobia, many banks, especially the American banks, are subject to many regulations like the stipulated capital to asset ratio. Thus many banks are forced to generate income without increasing their assets, and the most common method is to earn fee incomes. Consequently, more and more banks welcome the issue of FRN in place of the traditional syndication lending.

Because of the revolving nature of the FRN, the borrowers have the greater flexibility of revolving the notes at maturity and the freedom to issue at any time they need money. Also, the banks incur lower inherited risk by issuing FRN than syndicated loans, and hence they are willing to charge a lower interest spread on the former. The combined advantages of flexibility and lower charge are the major incentives welcomed by the highly-rated corporations to issue FRNs.

Compared to other fixed income generating instruments, the yield of FRN is relatively higher (usually 1/4 % above LIBOR), and because the borrowers are prestigious sovereign borrowers or corporations, the interest income is almost guaranteed. Moreover, FRNs can be traded in the secondary market and thus gives the investors more flexibility. The nature of the guranteed interest income and the flexibility makes FRN very attractive to both the institutional and individual investors.

CHAPTER 4

FLOATING RATE NOTES

4.1 Features of the Floating Rate Notes (FRNs)

4.1.1 Nature and History

Floating rate notes (FRNs) are bearer securities with floating interest rates. They were first developed in the Euromarket in the early 1970s as a debt instrument of fixed rate Eurobonds and floating rate Eurocurrency lending. It retains most of the features of a bond issue, and incorporates the concept of interest re-setting of bank term loans. FRNs, however, have become active in Asia only in the recent years as the financial markets here are less developed, especially the thin secondary market.

4.1.2 Participants

Because of the large principal amount of each FRN, only the prestigious, highly-rated corporations or financially healthy sovereign borrowers can issue FRNs. The merchant banks (or other investment houses and commercial banks) act as underwriters to underwrite and channel the issue of FRNs from the issuers to the institutional investors and to some small investors. The investors may be either banks, pension funds, insurance companies, institutional investors and some small investors. However, the whole of many FRN issues and large portions of the rest of FRN issues are held by banks and institutional investors. It is estimated by International Financial Review that 70 % of all FRNs end up in banks' investment portfolios. After the FRNs have been issued, they are listed on the stock exchanges (London or Luxembourg) for post-issue trading.

4.1.3 Denominations

FRNs can be denominated in a variety of currencies, but the most favoured one is US$. The total principal amount of each FRN is very large (usually from US$ 20 million to US$ 500 million), while the denomination of each FRN is small (may be as small as US$ 1000) to tap the smaller investors. In the secondary market, FRNs are traded in units of US$ 1 million.

4.1.4 Tenor

Most FRNs carry a 5 to 7 year maturity, with some up to 10 and 15 years, and the trend is toward longer tenors. Actually, a perpetual FRN has been issued by the Swedish Government.

4.1.5 Interest and Pricing

The interest rates are generally set at a certain spread above a reference rate, which is usually the six-month London Inter-bank Offered Rate (LIBOR), or in Hong Kong, the Hong Kong Inter-bank Offered Rate (HIBOR), to which it is reset at half-yearly intervals. The spread is around 1/4 % in recent years. The interest is calculated on the basis of the actual number of days, divided by a 360-year day. The calculation of the coupon can be illustrated by the following formula :-

Let r = Rate of interest

P = Principal amount of the note

d = Actual number of days

C = Coupon amount

$$C = \frac{r * P * d}{360}$$

The price of the FRN is that interest spread plus a front end fee, and are then quoted in the secondary market at a discount or premium to par. A hypothetical example of the fee structure for an FRN issue with a tender panel (to be explained in the next section) is as follows :-

Management Fee : 0.25 % flat payable to the Lead Manager

Placement Fee	: 0.0625 % payable to a tender panel on successfully bid FRN
Underwriting Fee	: 0.15 % p.a. to the underwriting banks
Commitment Fee	: 0.15 % p.a. to the underwriting banks
Maximum Yield for Underwriting Banks	: LIBOR + 0.25 %

4.1.6 Role of the Lead Manager

The Lead Manager should prepare the FRN offer so as to suit the prospective issuer's needs with respect to amount, tenor, pricing, minimum coupon, redemption, and issuing strategies. Once the issuer has given the right to the lead manager to arrange the FRN issue, the lead manager will instruct its legal counsel to commence drafting the documents to be negotiated first with the issuer and then with the other signatories of the documents. The types of documents and the parties involved are listed in Appendix 2.

At the same time the documents are being drafted, the lead manager has to form a management group, inviting banks to join it as co-managers in sharing the underwriting risk. Then the offering memorandum which contains considerable information, together with various documents, have to be prepared and presented to the stock exchange by a member broker. Finally, the managers will approach the prospective investors and dealers by sending them offer telexes describing the issue and inviting the recipient to join the seling group. The selling group members are prepared to purchase the securuties either for their own account or for onselling at par minus an amount less than the selling commission.

4.2 SNIF

Short-term Note Issuance Facility (SNIF), named as short-term Euronotes by some professionals, is just a short-term variatin of the Revolving Underwriting Facility (RUF). The medium or long-term RUF is simply the FRN, as discussed above.

The features of SNIF are very much alike those of FRNs, except the maturity is much shorter, usually from one to six months. The underwriting banks receive an underwriting fee for the risk that they have to take up the SNIF. But the SNIFs have minimum price levels set by the Lead Manager who believes that the SNIFs can be successfully placed at that price. The worst case for the underwriting banks is that they may be forced to take up their underwriting commitment. Since the risk of underwriting this SNIF is lower than that of underwriting a loan of similar maturity, the underwriting fees for SNIFs are comparatively lower. On the other hand, because of the short-term nature of the SNIF, the investors also accept lower yields. As a result, the cost to the borrower is significantly reduced.

To conclude, the borrower can be assured of the money when he needs it, and at a cheaper price. Moreover, the short-term paper can be rolled over and new notes can be issued throughout the life of the facility.

4.3 Variations of Floating-Rate Notes

The FRN, as pointed out above, is itself a hybrid, a combination of the characteristics of a bond and a loan. Thus, it is not surprising to find that the evolution of the instrument has not stopped, especially in the Euro security market. In order to accomplish the objectives: to reduce the cost of borrowing; to improve the maturity profile; and to shift the funding away from the bank credit to the security markets, the issuers and the bankers have to work out innovative deals with competitive price to attract investors.

The Kingdom of Sweden was elected the most innovative and successful borrower in the world in 1984 by most bankers. Under the borrowing programme, the Swedish launched a series of trailblazing deals in 1984: the 40-year, US$ 500 million FRN in February 1984, which doubled the previous record of maturity; the 25-year serial zero in the Yankee market in March; the first sovereign FRN in the Swiss franc market in April; the largest-ever capital issue in the United States domestic market, a US$ 1.5 billion FRN and Revolving Underwriting Facility (RUF) in April; the first perpetual sovereign FRN, the US$ 750 million flip-flop in JUNE; and a US$ 4 billion facility combining loans, advances and notes.

As seen from the above example, many variations, just resemble 'ingredients' or 'seasonings', can be added on to the

FRNs for repackaging them in order to make the FRNs look more appealling among other products in front of investors. The most commonly found variations are highlighted below, but they do not change the basic nature of the FRNs.

4.3.1 Put Option

The FRN holder has the option to sell the notes back to the issuer at par on a specified date prior to the date of maturity of the FRN, for example, a FRN with 10-year maturity may have put options at the end of years say 5 and 8.

4.3.2 Call Option

The issuer has the right to redeem the issue at par on a specific interest payment date or dates prior to maturity.

4.3.3 Convertible Tenor/Flip-Flop

The noteholder has the option to exchange its FRNs of one tenor for notes of a different tenor at par on a specified interest payment date or dates. An issue which allows the FRN holder having exercised the option to exchange notes of one tenor for notes of another the option on specific subsequent interest payment dates to re-exchange the notes for notes having the original tenor is called a "flip-flop".

The first "flip-flop" was issued in June 1984, when the Kingdom of Sweden launched the first-ever perpetual sovereign FRN. The addition of a perpetual FRN with first a flip option -- allowing the investor to convert his paper into a medium term note at a lower yield and then a flop option -- allowing the investor to change back to the perpetual instrument, made up the flip- flop.

The technique allows the investor to flip out of his perpetual FRN, which yields a quarter percent above LIBOR, into a four-year note yielding the Mean Between London Inter-bank Offered And Bid Rate (LIMEAN). The investor has this option once a year, and once a year he can also flop back into the perpetual note. The flip option encourages the investor to accept a relatively low yield in his perpetual FRN. In a panic situation, the investor may wish to get out of the undated bond, but if confidence returns he can get back into the higher-yielding perpetual.

4.3.4 Convertible Security

The noteholder has the option to convert the FRN into a different form of debt security, for example fixed-rate debt at a specific date or an equity security, like preferred shares at a specific conversion rate on a specific interest payment date or dates.

4.3.5 Perpetual FRNs

The note has no formal maturity (i.e. the principal of the note does not have to be repaid) except in the event of an interest payment default. Therefore, perpetual notes can only be sold by top-qulaity borrowers of the highest credit standing like the Kingdom of Sweden, the Kingdom of Denmark, Belgium or the World Bank, all of which enjoy a triple A Rating.

4.3.6 FRN/Loan Hybrid

This is an FRN with put option(s) on specific date(s), and a bank facility that would advance funds to the issuer if investor exercised their put option(s).

The first deal to combine FRN with an underwriting facility similar to the RUF was issued by Sweden amounting US$ 1.5 billion, the largest-ever securities issue in the United States. The structure was a seven-year FRN issue, with an annual put option and a bank facility.

Because under the Glass - Steagall Act, United States banks are prevented from placing securities, the bank side of the deal could not be structured as a simple underwriting facility. If the investor exercises his put option, the notes go back to Sweden, not the banks. Sweden's fiscal agent, the commercial bank, holds the notes. Another security broker or investment bank tries to remarket the notes. If it cannot, it advises the commercial bank who then advises the bank's syndicated agent, which then organizes the lending to Sweden of an amount equivalent to the unplaced FRNs.

The key to the structure is the one-year put option on ther FRNs: it allows Sweden much sharper pricing (40 basis point under US prime, or 55 over three-month CDs), and it would not have been possible to issue such a large FRN with a simple maturity of seven years. The one-year put encouraged United Stated money market investors to buy the deal,with most of the FRNs going to persion funds, Saving & Loan Associations, banks and corporations. Eigthteen percent of the FRNs went overseas to central banks.

4.3.7 FRN/Loan/Advance Hybrid

The hybrid is basically a flexible cash management tool, a flexible concept to replace existing largely undrawn revolving credit. A US$ 4 billion 10- year hybrid was first launched in June 1984, with three options for the borrower (Sweden).

The first option is that the borrower can borrow at an eighth percent above LIBOR, on top of a facility fee of an eighth percent, but if the borrower uses more than one third of it, the spread it pays rises.

The other two options are in addition to the first option.

The short-term advance option allows the borrower to ask the bank to bid to lend it money, since some banks are more asset-hungry than others. As with the short-term advance option, there is no limit to the amount the borrower can issue short-term notes for which the price will be determined on a tender basis. If market conditions are right, these notes, being liquid, should provide cheaper money than the other two options.

4.3.8 Warrant

A warrant gives the noteholder the option to subscribe for other fixed or floating rate debt of the issuer or to buy equity in the issuer on specified terms within a specified period. The warrants are issued at the same time as the FRNs and may be sold attached to the FRN or separately. Warrants have a value of their own depending on the terms of the debt or equity which may be purchased on exercise of the warrants and the market's forecasts of the future interest rate or equity price developments. This value may be used to reduce the cost to the issuer of the FRNs to which warrants are attached.

4.3.9 Guarantor Underwritten Notes (GUNs)

Banks can guarantee an FRN either through a gurantee of payment (by way of a standby letter of credit ot guarantee) or through an undertaking to repurchase the FRNs at par upon the occurrence of an event of default. The issuer may benefit from issuing a bank guaranteed FRN in one of several ways, all of which stem from the enhanced liquidity and marketability which the bank guarantee can bring, thereby allowing the issuer to tap new source of finance. This may result in a lower overall cost of borrowing. It may also enhance the market prestige of an issuer, preparing the way for other unsupported FRN issues in the future.

4.3.10 Bearer Notes

Withholding-tax-exempt bearer notes are medium term paper with a put option to the underwriting banks. The put option allows investors to classify them as short-term paper and bank risk. Bearer notes are issued by borrowers in certain countries with withholding tax range (notably Australia) term.

4.3.11 Floating Rate Serial Notes (FRSNs)

The floating-rate serial notes differ from the typical FRNs in only one characteristic: instead of organizing the redemption through market purchases or lots, FRSNs provide for a real amortization of the issue. Beside having coupons, the FRSNs have "boxes" which are used by the note holder to receive the periodic redemption share. At each partial redemption, the paying agent pays the coupon and, provided the note is presented at the same time, the principal is redeemed. The paying agent cancels the relevant box. It guarantees a reduced average life without running the risk of an earlier redemption at par.

4.4 Placing Methods

There are basically three methods of placing a revolving underwriting facility (RUF). The three methods have their own drawbacks and a fourth, which is a hybrid of the three basic methods, has recently been developed and is regarded as superior to the previous methods.

4.4.1 Multiple Placing Agency

The first traditional placing method is the multiple placing agency (MPA), which gives each underwriter from the beginning of each offering period, the right to call its pro-rata share of the tranche of short- term papers. The advantage of this method is that it provides each underwriterr with the certainty of an allotment, so that it can make firm offers to the investors, and the underwriter may a earn selling commission.

The major disadvantage of this MPA method however, is that a good vendor of short-term paper may not necessarily have the financial strength and understand medium-term credit risk and thus be a good medium-term vendor as well. In other words, there are in practice many weak vendors in the MPA competing among themselves, thereby driving up the yields and lowering the profitability of the placement. Also, a placement at a high yield near the contracted level will adversely affect the terms of the next issue. Actually, MPA has already been out of fashion.

4.4.2 Sole Placing Agency

The sole placing agency (SPA) method was used for most of the early RUFs, by which one investment bank was willing to take up the repetitive task of selling short-term paper issued under the RUFs it had arranged. The first advantage of SPA was that the difference between the contracted yield and the yield given to the short-term investors provided the necessary incentive for the sole placing agent to place at the lowest yield. There were also economies of scale, and the issuer's paper was offered to the short-term market in an orderly way, instead of as in the case of MPA.

Strong objections to SPA, however, have never stopped from the commercial banks. These commercial banks wish to be able to sell the short-term paper which they underwrite, so that they can augment their return on their underwriting commitments. Some other commercial banks, in light of the trend toward securitization of the international credit market, want to use short-term paper to develop their own securities placement capacity.

4.4.3 Tender Panel

Under the tender panel method (TP), all the bank underwriters make their bids and only those making high bids can get an allocation of paper. The market yield level is determined by the panel members with the strongest placement capability, and the issuer can benefit from the yield savings too.

This method has many drawbacks. Firstly, there is no one party to assume the responsibility and accountability to the issuer for the successful placement of the paper at low yield levels, especially during more difficult market conditions. Secondly, there is only one tender for each drawdown, usually made during the afternoon before the interest- rate fixing date. The panel members are thus obliged to offer the paper to investors only on a tentative basis during the offering period before the tender deadline. That means they cannot confirm investor demand when it is identified. Many panel members, having experienced embarrassment with investor clients, and having failed to make a profit on placement, are reluctant to take part in more panels. Finally, the fact that the offering period is closed off on the day before the interest-rate fixing date, prevents the sale of paper during overnight Asian business hours and in London during the few hours before the interest-rate fixing. Thus many corporate investors who would like to be able to see the trend of short-term interest rate movement before they commit are hesitant to buy the paper.

4.4.4 Continuous Tender Panel

This is an improvement over the TP method. The continuous tender panel (CTP) manager allots CTP paper on a continuous basis. For each CTP tranche offering period, the managing underwriters will form an exclusive CTP, which will be in continuous session until the tranche has been fully subscribed. The tranche will be sold by any combination of the following :

1. Sales by the CTP manager to the CTP members at the strike offering yield.
2. Sales by the CTP manager to its own investor clients, also at the strike offering yield.
3. At the full contracted yield level, by pro rata allocations to the underwriters of any paper remaining unsold through 1 and 2.

The strike offering yield is the offering yield quoted by the CTP manager, from time to time, to its investor clients. The CTP manager will also advise ther panel members of the strike offering yield throughout the offering period, until full subscription.

The CTP method has many advantages over the three traditional methods. First of all, the CTP method can provide an orderly and controlled distribution environment for the issuer, as in the case of SPA. For the underwriters, the strike offering yield provides a realistic basis for panel members' discussions with their investor clients. If the clients are interested, the panel member may secure protection from the CTP manager while confirming the sale. Moreover, as tenders may be submitted at different times during the continuous offering, the panel member has the utmost possible opportunity to sell. These can all reduce the risk of wasting efforts inherent in the conventional panel method. Finally, since the continuous offering period extends to the interest-rate fixing date, the underwriters can more easily sell to non-bank investors who would like to see the way interest rates are going before they commit themselves. These corporate investors are very important for the success and survival of the EUF.

4.5 Advantages of disadvantages of FRNs

4.5.1 Advantages

In recent years, the syndicated loan market has largely been out- performed by developments in the capital markets and by the introduction of FRN. As a source of funds for international borrowers, the Euroloan market has declined drastically, operating in 1984 at only about 60 % of the peak volume achieved in 1981. FRNs are undoubtedly a response to the changing market requirements: the desire for liquidity on one hand and for more competitively priced funding on the other.

4.5.1.1 Security Conscious

Security conscious. That is perhaps the best way of describing the present international capital markets. A big influence on the development of FRN has been the debt crisis of the developing countries, which highlighted one of the prinicipal attributes of the FRN -- liquidity. Banks extremely cautious of judging credit worthiness become particularly concerned with liquidity of assets and begin to put FRNs into their lending portfolios (despite the reduction in overall return compared with syndicated loans). Moreover, many banks now have so much rescheduled debt on their books that they are looking for way to make the rest of their balance sheets more flexible. In the process, they have begun to shy away from long-term lending, preferring instead to place their money in short-term negotiable instruments that can be sold quickly if necessary.

Coupled with the slowdown of the interbank deposit market after the eruption of the debt crisis in 1982, large banks which still have a surplus of short-term money to pass on to their customers have fewer outlets than before. Smaller banks are playing a much reduced role in the deposit market and even some sizable institutions have become suspect as the case of Continiential Illinois shows. The implication is that it is safer to purchase FRN in a short to medium term from top quality issuers like the Kingdom of Sweden or France, than to put the money in another bank. This form of security conscious diversification is not only clear in the mind of bankers, but also in the mind of non-bank investors such as corporate treasurers and central banks.

The declining revenues of the Organzation of Petroleum Exporting Countries (OPEC) have slown down the recycling of oil money and made it harder for them to attract deposits from overseas. However, countries like Saudi Arabia, Kuwait, and Malaysia need huge sum of money to finance their projects and infrastructure development. As banks are growing more concerned about their credit worthiness, they have had no choice but to cede business in the capital to the more efficient and sophisticated securities markets.

The whole international banking industry had been looking for ways of increasing earnings without increasing assets, i.e. increasing fee income by conducting business which does not automatically swell balance sheets and upset capital-to-asset gearing ratios. With the emphasis given by regulators in the United States to the adequacy of banks' capital ratios becoming much stronger in 1983, the solution now is to sell down loans or to shift from syndicated loans to instruments like FRNs. In the process of issuing FRNs, merchant banks only act as the underwriter (or one of the underwriters) or a member in the tender panel or just as a financial advisor to the issuer. Therefore the risk of default on payment of the notes is not born by the banks but by the investors, provided the FRNs are fully subscribed. Acting as brokers or agents, banks can also earn asset-free based revenues.

From the borrowers' viewpoint, the FRN is a more flexible financing vehicle than the syndicated loan and other long-term instruments. FRNs are usually medium to short term papers and can be rolled-over after maturity at the borrowers' discretion. A syndicated loan, however, is a long-term instrument, a once-for-all commitment by both parties, borrowers and lenders. Of course, the loan can be restructured when required, but it is more costly and inflexible.

4.5.1.2. Pricing

FRNs attract investors during times of expected rise in interest rates. When rising interest rates are forecasted. investors will tend to sell long-term fixed rate bonds and instead place their funds in shorter maturity instruments like Negotiable Certificates of Deposits (NCDs), short-term bank deposits, and FRNs, because of the fixed margin or spread over the London Inter Bank Offering Rate (LIBOR) or the Hongkong Inter Bank Offering Rate (HIBOR). FRNs therefore assure investors of a higher yield than bank deposits and NCDs which are fixed-rate instruments. Usually, the interest rates of FRNs are fine-tuned at a quarter or an eigthth over LIBOR or HIBOR depending on the quality of the papers.

FRNs are most attractive when interest rates trends appear uncertain and volatile. As mentioned earlier, investors gain by the rise of interest rate or LIBOR. On the other hand, FRNs are a logical choice to investors with expectation of declining interest rates in the fluctuating circumstances, for FRNs provide investors with an assurance of a minimum yield on their investments.

The secondary market price levels of FRNs often demonstrate good resistance against prices declines. This is because of the negotiable and transferrable nature of the notes. Risk averting and risk taking investors may foresee the yield of the notes differently. To cite an example, if a pessemistic investor predicts that the future HIBOR will decrease, therefore lowering the yield of the note, the investor may sell his notes in the secondary market and invest in another instrument. However, an optismistic investor may buy those notes because he predicts that the future HIBOR or market price of the notes will rise. By and large, FRNs provide investors with an open possibility of a higher return, and with a safty valve to safeguard the investors' minimum acceptable return.

FRNs also serves as an instrument to hedge against inflation because of its floating-rate nature.

Various kinds of 'ingredients' or variations can be built into the FRNs to provide investors with more flexibility, and therefore additional liquidity, while depth and variety are less common in syndicated loans and other fixed-rate instruments. In this way, FRNs are more welcome by investors and more ready for trading.

From the merchant banks' viewpoint, they only work as underwriters and resell the FRNs to investors; therefore their commitment are minimal. Of course, banks can gain from trading these papers, especially when interest rates fluctuate.

Without much commitment compared with loans, banks are more flexible and liquid in diversifying their own portfolio. Hence, liquidity keeps the banks from being tie up by various constraints.

The availability of large amounts of money to lend no longer counts for much when their customers can raise chaeper funds elsewhere. The strength of the merchant banks lie in their highly developed ability to provide just this service. By securitizing debt and making it negotiable they are able to sell it direct to investors, by-passing the intermediatory role performed by the loan syndicators. This can sometimes be done at rates lower than those at which banks can afford to lend. A top quality borrower like the Kingdom of Swedon, is able to borrow in the Euronote market at five basis point lower then the London Inter Bank Bid Rate (LIBID) for Euro dollar deposits, which constitutes the actual cost of funds to finance the banking system.

4.5.2 Disadvantages

For investors, the purchase of FRNs even at today's fine rates brings in a little more interest than a bank deposit. But taken to its logical conclusion, the process whereby investors substitute bank deposits for FRNs could have some impact on the whole banking industry. It means that the banks risk being squeezed out of their traditional business of taking money from one customer and lending it out at a profit. In the FRN facility, they can find themselves bypassed, except as guarantors. As the banks' best customers drift away, banks will be left holding only credits to poor-quality borrowers in their own portfolios. At the extreme, this process forces the banks to fall back on those borrowers whose credit ratings are so low they cannot borrow in the notes market. The overall quality of their assets would then decline.

The FRN is an instrument only for good quality borrowers who can meet the stringent London Stock Exchange requirements and rank high in Moody's rating. Since the success of the FRNs depends on the reputation of the issuers and tradeability of the notes, but not just the term of the notes, therefore medium to low quality or new borrowers can hardly take advantage of the FRN market.

As the FRN market grows more sophisticated, borrowers become more cautious about reducing the cost of borrowing and the banks are more conscious of profit. But the number of top-quality borrowers are lessening while there are many banks who wish to share a part of the pie or enhance their visibility in the international chart. Price competition among banks leads to lowering yields and fees. FRNs may not be as attractive to banks in markets where margins are rising as they are in times of falling margins. Eventually, banks may be reluctant to do this thin margin business.

4.6 Advantages of the Syndicated Loan over FRNs

The syndicated loan will still be an important financial vehicle and will not be fully replaced by security facilities. Syndicated lending provides some operational flexibilities over FRNs to borrowers.

4.6.1 The Drawdown

The existence of a drawdown period, during which the borrower adjusts his drawings according to his financial needs, is a flexibility offered by syndicated loan. In the case of FRNs, the full amount is paid on single date against delivery of the notes.

Standby clauses available for roll-over credits authorize the borrower to adjust his drawings during the life of the loan. With such clauses, the borrower can repay the whole or part of the loan and, borrow again later. In the case of FRNs, the full amount is drawn at one time, repaid only at maturity or according to the redemption clauses of the issue.

4.6.2 Multicurrency

A syndicated loan may contain the provision of a multicurrency clause which give the borrower the possibility of adjusting the currency borrowed according to his needs. FRNs are more rigid as a borrowing instrument than syndicated loans.

4.6.3 The Placing Memorandum

The Placing Memorandum is an essential element of the marketing and advertising of an FRN issue and, most issues being listed on one or more stock exchanges, they necessarily include the preparation of a prospectus. FRN issues are generally wider than those for syndicated loans, so the number of underwriters, institutional and individual investors reached is important. In the case of syndicated loans, the circulation will be much narrower.

The composition, printing, packaging and posting of a placing memorandum for an FRN, which may run to several thousands of copies, and is normally issued in two versions (the preliminary prospectus being issued at the time of sending out invitations to subscibe, and the final prospectus being issued at the time of the offering itself), is a lengthy and complex procedure which requires time, attention and money.

4.6.4 Listing Procedures

In principle, with the exception of private placements, FRNs are listed oin one or more stock exchanges. The procedures vary according to the stock exchange involved: time problems, advertising problems, placing memorandum, documentation, and so forth. Nothing equivalent to the listing procedures exists in the case of a syndicated loan.

4.6.5 Fees and Expenses

The costs involved in an FRN issue, including printing, delivering, of prospectus, as well as notes, together with the expenses linked with the listing are a pure extra charge to the borrower.

4.7 Factors Affecting The Secondary Market Price of FRNs

In a market of stable interest rates, secondary market prices should not remain unchanged: possible disturbances, market expectations and characteristics of a particular issue are elements which, even under stable interest rates, influence the pricing of the notes. Some essential elements are mentioned below.

4.7.1 Foreign Exchange Markets

The demand for FRNs can be influenced by the evolution of that denominated currency on the exchange markets, for example, a weak US dollar will induce FRN holders to switch to financial assets denominated in another currency. Conversely, a strong US dollar may well push prices up, the investors being interested in investing in US dollar assets. On the supply side of the FRN, it may be less sensitive to foreign exchange fluctuations. However, a strong currency may discourage some borrowers who may be encouraged to launch FRNs if the currency is weak.

4.7.2 Call Option

If an FRN issue is approaching or entering the period when the issue is callable by the borrowers, the price in the secondary market will be influenced by this option. In principle, this call option will influence the level of the secondary market prices if the issue is traded above par. The influence will increase progressively as the date of the call option approaches.

4.7.3 Redemption

If an FRN issue approaches its maturity, the price tends towards par even if, under current interest rate circumstances, the price could be above or below par. Thus, the sinking fund can operate either through purchases in the secondary market or by selecting by lot the FRNs which are repaid at par on the next interest payment date.

If the issue is traded above par, the borrower is unlikely to purchase on the secondary market. Then the risk of selection by lot at par will influence the secondary market prices towards the par price. If the issue is traded at par, and especially if it is traded below par, the borrower, through the sinking fund agent, will purchase the FRNs in the secondary market. Then, these purchases will push the prices up, towards par.

4.7.4 Changes in The Borrower's Situation

If the financial situation of the borrower is worsening, some FRN note holders will try to sell their notes and switch to borrowers whose quality is more in line with their investment policy. On the other hand, if the situation is improving, buyers for those FRNs will appear. Such movements will influence the secondary market prices.

4.7.5 Political and Economic Uncertainties

In particularly disturbed times, such as wars, oil crisis, or dropping credit rating of the country, some investors have reacted by switching from monetary assets to other assets such as gold, precious metals, and hard currency. Such an attitude influences the demand and supply for FRNs, as it does for other financial assets.

4.7.6 Market Expectation

If investors expect an increase in short-term rates, they might react by selling fixed-rate securities before such an increase occurs and switch to FRNs to take advantage of the increase in short-term rates. Inversely, a switch from FRNs towards fixed rate securities will influence secondary market prices downwards if the investors expect rates to decrease.

4.7.7 Evolution of the Syndicated Loan Market

If the terms and conditions of a syndicated loan change, this will have a direct influence on the willingness of banks to buy, keep or sell FRNs. If spreads decrease on the syndicated loan market, FRNs will become more attractive and banks will decide to keep or buy FRNs as an alternative to their loan portfolio. Alternatively, they may sell FRNs in order to increase their participation in a syndicated loan. These movements will influence market prices.

4.8 Example of a Recent FRN Issue in Hong Kong

Though later than the western counterparts, Hong Kong had her first FRN issued last September. This is an important breakthrough to widen the the financial market in Hong Kong. There was another FRN issue last September denominated in US dollars, by the same company, the Mass Transit Railway Corporation. The two issues amounted to a total of US$ 139 million, as listed already in Table 4 of Section 2.2. The important features of the first issue are listed below as an illustration, and the Information Memorandum of the issue is enclosed as Appendix 3.

Date	: September 3, 1984
Issuer	: Mass Transit Railway Corporation
Lead Manager	: Morgan Guaranty Ltd., together with twenty-one other financial institutions as managers in the tender panel
Denomination	: HK$ 500,000,000
Tenor	: 8 years, due 1992
Interest	: Interest will be payable quarterly at 1/4 % p.a. above HIBOR for three month Hong Kong dollar deposits for each interest period quoted by reference banks.

CHAPTER 5

5.1 The Swap Market

A swap is based on the exchange by one party of a benefit which enjoys in a particular marketplace for a corresponding benefit available to another party in a different market. The principle underlying the swaps market is therefore for a borrower to access the market on which he gets the best reception , and then to use swaps to manage separately and optimally the currency and interest rate basis on which to take the funds. Similarly, investors can use swaps to unbundle the choice of which issuers' paper to buy from the currency and interest basis of the investment.

The growth of the swap market is attributable to a number of factors: volatile interest rates, floating exchange rates and variable credit market conditions during. There are probably as many different types of swap arrangements as there are types of debt financing. The more common types of swaps are interest rate swaps and currency swaps. Some common arrangements are cited in fugure 1 on the following page.

FIGURE 1

Common Arrangements of Swap

From	To	Currency	Example
Fixed interest	Fixed interest	Different	Conversion of a fixed liability in Swfr. to fixed interest liability in US dollar.
Floating interest	Floating interest	Different	Conversion of a floating-rate US dollar liability into a floating-rate Swfr. liability.
Floating interest	Fixed interest	Same	Fixing the interest cost of a variable-rate syndicated Euro dollar loan.
Fixed interest	Floating interest	Different	Swapping proceeds of a Swfr. private placement into floating rate US dollar.
Floating interest	Floating interest	Same	Conversion to LIBOR basis of funds borrowed through US commercial paper market.

5.1.1 Fixed/Floating Interest Rate Swap

An interest rate swap is a transaction whereby an asset or liability held at a floating rate of interest can be converted effectively to a fixed-rate, and vice versa. It is not necessary that the two parties involved have different interest rate expectation. The borrower who has the ability to borrow fixed rate already may have utilized all of its floating-rate lines. The party seeking fixed-rate financing may be undertaking a capital investment project that cannot bear the uncertainties attached to floating-rate financing.

It is a counterparty transaction. That is, it depends upon finding two companies with equal but opposite needs to exchange their respective positions. For example, assume that Company A is a highly-rated borrower in a position to borrow both fixed-rate and floating-rate funds at 12 percent and 10 percent respectively. Company B, on the other hand, which has a lower credit rating, must pay 11 percent for floating-rate funds and 15 percent for fixed-rate funds. Company A then proceed to borrow fixed at 12 percent, Company B borrows at a floating-rate of 11 percent. In addition, Company B agrees to absorb 3 percent of Company A's interest cost. At that point, Company A has borrowed at a floating- rate of 9 percent (12 minus 3) with Company B obtaining fixed rate funds at 14 percent (11 plus 3). In ths case at point, both corporations have benefited from swapping their interest rates.

The principal never changes hands. Only the interest is paid. In fact, it is not interest because there is no loan or deposit involved in the swap: it is simply an agreement between parties to make payments which are calculated as though there were interest. In practice, these payments are usually netted, so that at each settlement date only the difference between the two amounts is actually paid. This has the advantage of administrative convenience and might also produce a lower liability to withholding tax if the payments amounted to interest were liable to withholding tax.

From the borrower's viewpoint, through a swap, he can fix the cost of a floating-rate liability (loan, lease, etc.), and manage down the cost of fixed-rate funds when interest rates are declining. Interest rate swaps can, of course, be used to manage interest exposure without affecting the underlying sources of funds.

For banks entering into a swap, they can issue fixed-rate instruments like bonds, CDs by paying floating-rate interest and managing the interest gap.

Investors holding a portfolio of floating-rate instruments to provide a fixed-rate yield can minimize exposure to capital losses and improve liquidity. Those holding fixed-rate instruments with a swap into convert to a variable rate yield can provide a better yield than a comparable FRN.

5.1.2 Fixed-Rate Currency Swap

A currency swap is the purchase of a currency and the sale simultaneously of the same amount of that currency, but with different delivery dates for the purchases and sale. Again, it is a counterparty transaction. For example, Company C borrows US dollars at a fixed-rate and Company D borrows Swiss-franc also at fixed-rate. Company C agrees to provide Company D the Swiss-franc cash flows required to meet the payments due; in turn, Company D provides the US dollar cash flow to satisfy Company C's debt. At the termination of the currency swap agreement, which generally coincides with the maturity of the underlying debt, each party agrees to exchange the nominal principal amount in each underlying currency.

A currency swap is used to assist a company in obtaining a currency which it may be precluded from securing at a comparable cost, for example, converting export credit transactions into the required currency, or to reduce the foreign exchange risks related to debt. Moreover, the borrower may have access to generate funds in the cheapest market or in a currency in which there is no direct borrowing available in long-term fixed-rate funds -- for example Euro-French franc, then swaps them into the desired currency.

5.1.3 Option Contract on Fixed/Floating Interest Rate Swap

This arrangement is the hybrid of an interest swap and an option contract, i.e. an agreement entered today for an interest rate swap to take effect on a future date on predetermined terms.

The fixed-rate applying to the swap is set by reference to the secondary market yield on a defined security. For example, it might be set as 80 equivalent basis point above the yield on the US Treasury bond of coupon 11 3/4%, maturing January 1991. The floating-rate will be indexed to LIBOR or to some other agreed yardstick, such as US prime, or Treasury Bill yield. The optionee will then have the right to require the option writer to enter into an interest rate swap on the agreed terms on the date the option is exercised.

Two types of options have become commonplace fairly recently. The first is a timing option, under which the optionee can select the date on which to exercise the option but is obliged to exercise on or before the expiry date of the option. The other is a true option under which the optionee has the right to require the swap to come into effect, but has no obligation to do so.

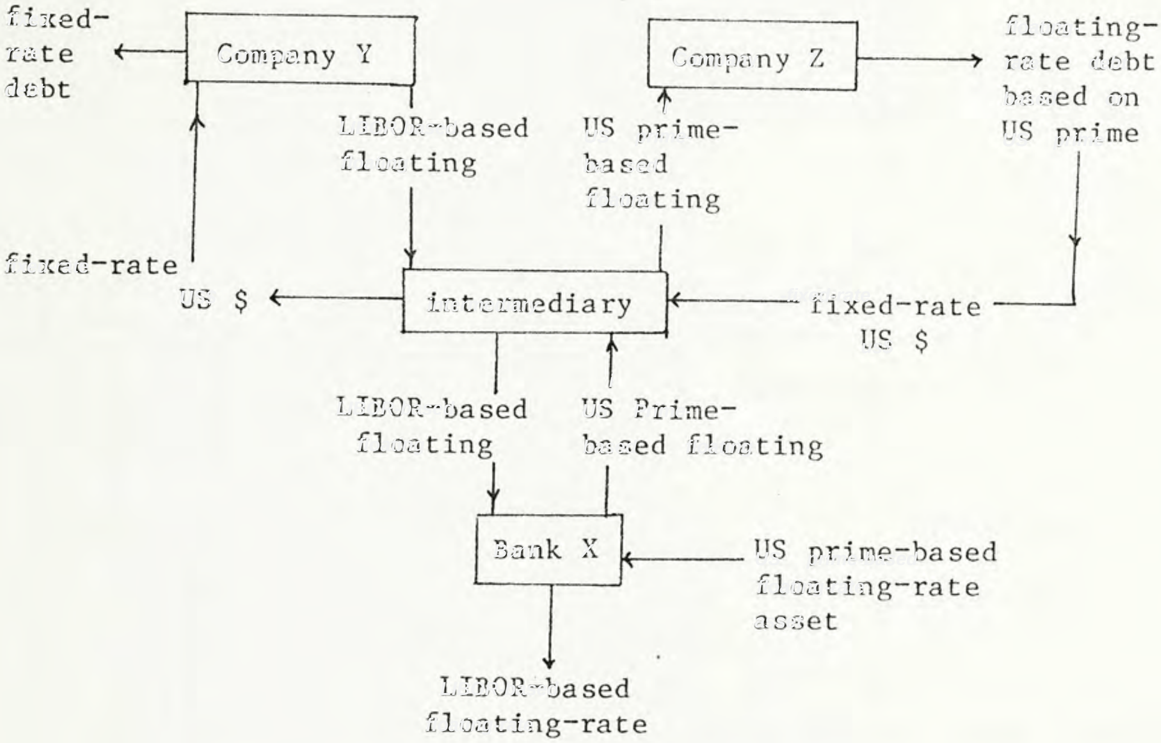
5.1.4 Basis Swap

A basis swap is the conversion of a floating-rate asset/liability one currency into a floating-rate asset/liability in the same currency, but using a different rate-setting mechanism. As with a fixed/floating interest swap, the principal never changes hands. Again, it might be arranged by finding two companies with equal but opposite needs, but more usually it is a three-party transaction.

Suppose, for example, Bank X, which has access to floating-rate liability based on LIBOR, and also has a US prime-based asset for which it seeks matched funding. It then enters into a swap whereby it receives an amount linked to LIBOR and pays an amount related to US prime. The other two offsetting counterparties could be Company Y, swapping between a fixed-rate and LIBOR-based floating, and Company Z, swapping between US prime-floating and a fixed-rate. The arrangement is depicted below in figure 2. The two fixed-rates can then be arranged to cancel each other, leaving a residual position which is US prime against LIBOR.

FIGURE 2

Basis Swap

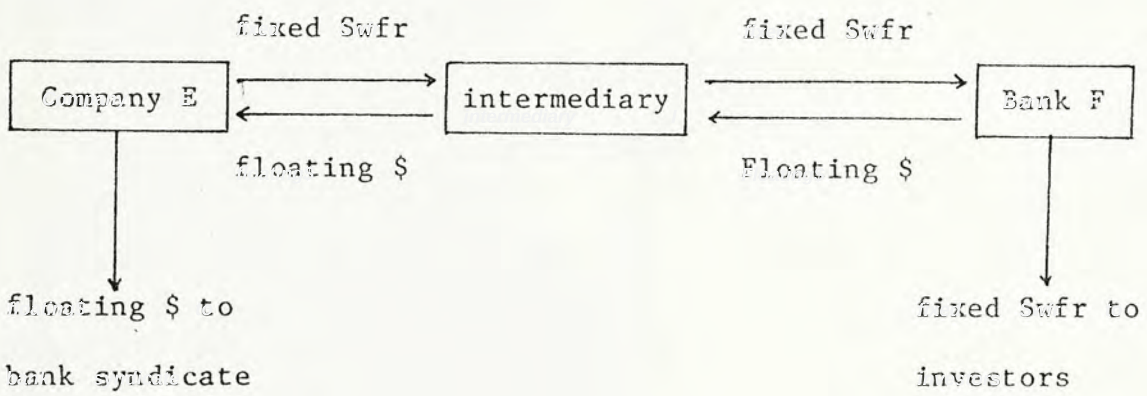


5.1.5 Cross-Currency Interest Swap

A cross-currency interest rate swap is a conversion of a floating- rate liability is one currency into a fixed interest liability in a different currency, and vice versa. For example, Company E has an US dollar floating-rate syndicated loan, which it wished to swap into fixed-rate Swiss francs. Bank F wishes to raise floating-rate dollars more cheaply than can otherwise be obtained from an FRN or an Floating- Rate Certificate of Deposits (FRCDs). This can be achieved through a Swiss franc private placement swapping into floating-rate dollars, as illustrated in figure 3 below.

FIGURE 3

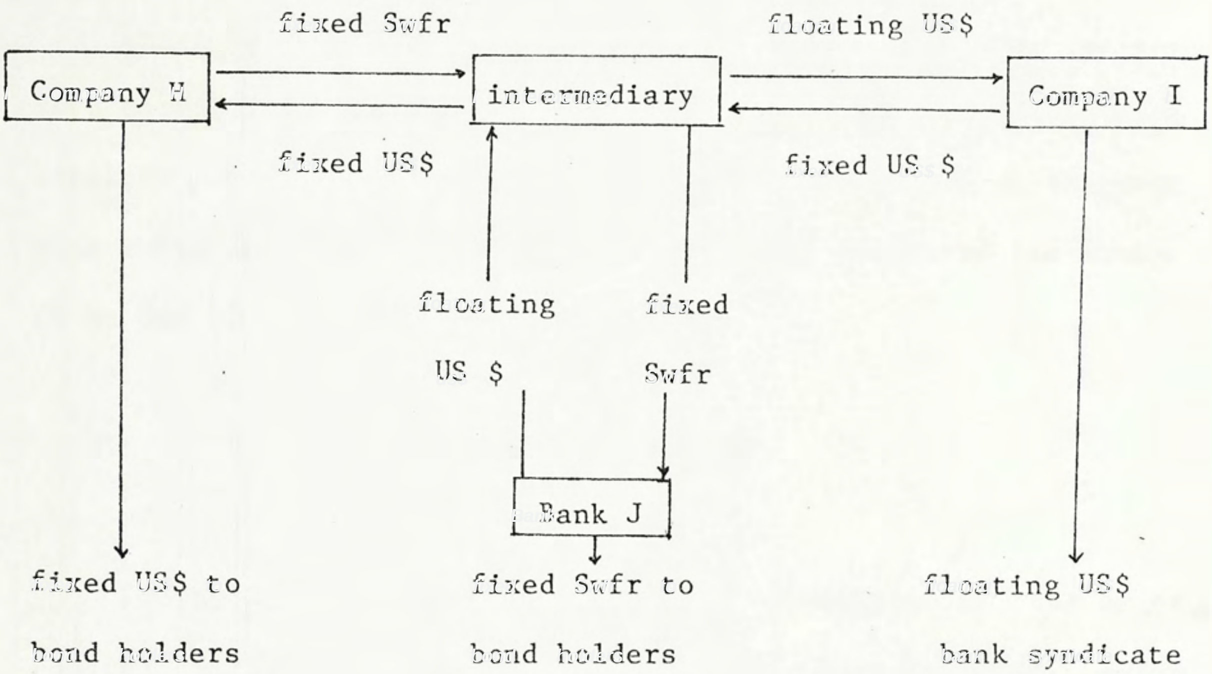
Cross-Currency Interest Swap (2 parties)



More recently, it has become common for at least three parties to participate in such a transaction. Instead of the two parties swapping a floating liability in one currency and a fixed liability in another currency, the package will comprise both a forex and a single currency interest rate swap. For example: Company H raised fixed-rate dollars through a bond issue and swaps into fixed-rate Swiss franc. Company I borrows floating- rate dollars from a syndicate of banks and swaps into fixed dollars. Bank J issues Swiss franc bonds and swaps into floating-rate dollars. The situation is depicted in figure 4 on the next page.

FIGURE 4

Cross-currency Interest Swap (3 parties)



5.2 Swap Market Characteristics

5.2.1 Volume

There is no reliable statistics on the overall size of the swap market. In its review of capital markets in 1983, Salomon Brothers put the number at US$ 14 billion; 10 billion in interest rate swaps and 4 in currency swaps. Euromoney estimated the market to be US$ 20 billion.

5.2.2 Currencies

The bulk of the volume is in the currencies of the major capital market -- US dollars, Sterling, Deutschemarks, Swiss francs, Yen, Dutch guilders, ECUs and Canadian dollars.

5.2.3 Maturities

The long-dated market starts from about three years. Below that, the conventional exchange markets are too efficient to make it economic to search for specifically matching counterparties to a transaction. Most long-dated swaps have final maturities in the five to ten years range, although longer deals happen from time to time; for example, when coupled with leasing transactions for major capital goods.

5.2.4 Amounts

Individual transactions range in size from US$ 5 million (below which the fixed component cost of arranging the transaction becomes uneconomic) to US$ 500 million and up.

5.3 Current Swap Market in Hong Kong

The publicly-known interest rate and currency swaps first appeared in Hong Kong in March and April 1985. So far, four transactions involving fixed/floating interest rate and cross-currency interest rate swaps have been publicized. They are listed in Figure 5 on the next page.

FIGURE 5

Swap Arrangements in Hong Kong, 1985

The Company	The Bank(s)	Amount	Facility issued by bank
The Hongkong Land Co.Ltd.	Bank of Tokyo's HK Branch	HK$ 100 Million	HK$ 100 Mn. 3-yr fixed-rate CD
The Hongkong Land Co.Ltd.	Mitsui Bank's HK Branch	HK$ 100 Million	HK$ 100 MN. 3-yr fixed-rate CD
The Kowloon Electricity Supply Co. Ltd. (Kesco)	First Nat'l Bank of Chicago/Manu. Hanover Asia Ltd/ Schroders Asia	US$ 175 Million	
The Hongkong Land Co.Ltd.	Dai-Ichi Bank's HK Branch	HK$ 100 Million	HK$ 100 Mn. 4-yr CD (fixed-at 10 3/4% for the first 3 yr, HIBOR + 1/4% for the 4th yr.; callable at the end of the third yr.)

Source: From 1. South China Morning Post, April 22 & 24, 1985

2. Hong Kong Economic Journal, April 24, 1985

As seen from the above transactions, banks in Hong Kong are increasingly issuing fixed-rate Certificates of Deposit (CDs) and then swap them, usually with a big company which has loan carrying floating- rate interest, so that banks can secure funding at a margin below the HIBOR.

Companies like Hongkong Land decide to lock in part of their interest cost over the next three years by means of swaps so that they could be protected, at least to a certain extent, from the interest rate fluctuation and could also calculate the exact interest cost for the coming three years.

Companies like Kesco, which have Hong Kong dollars receivables and some foreign currency liabilities benefit by swapping with banks which have foreign currencies receivables and Hong Kong dollar liabilities. Banks are the most suited candidates to be a counterparty in these swap transactions for they are taking advantages of the fact that fixed-rate CDs can be placed more easily now than a year ago.

There are two main requirements to do swap-linked fixed rate CDs transactions. First, there has to be a demand for the fixed rate securities and second there must be parties willing to do the swap. The fast development of the fixed-rate CDs market this year may be attributed to the success of three issues last year, which convinced bankers that the future instruments will be of longer maturity, possible in larger amounts and perhaps have a slightly more complicated swap structure.

CHAPTER 6

OTHER NEW FINANCIAL VEHICLES

There are many experienced experts in the Hong Kong merchant banking sector, and they have to introduce new financial services all the time to attract and satisfy customers. Besides the flourish of floating rate notes and swaps in recent years, there are other new developments in the tax-related aspects and short-cuts to become a listed company.

6.1 Tax-based Leverage Lease

Some companies, especially the airline companies, don't have to pay profits tax and cannot claim depreciation allowances. Therefore, they can sell their fixed assets (e.g. aircrafts) to other tax paying companies which can then claim depreciation allowances and obtain tax benefits. The original company in turn can lease back the fixed assets at a lower rent and hence to increase its profitability.

6.2 Backdoor Listing

In order to bypass the regulations required for listing on the Hong Kong Stock Exchange, such as five years good business record in Hong Kong, an overseas or a newly developed local enterprise may merge or acquire a small local company which fulfils those prerequisites for listing. In this way, the overseas or the newly developed enterprise can go public and can be listed in the Hong Kong Stock Exchange on a relatively short time.

6.3 Reverse Takeover

This is another way to bypass the listing regulations or to achieve a faster listing. A large company which has not yet been listed can just exchange shares with an existing listed company so it becomes the majority shareholder of the listed company. Apparently it is the existing listed company that has taken over the larger company. In fact, however, it is the larger company which has acquired the existing listed company because by then the larger company has majority voting right in both companies.

CHAPTER 7

CONCLUSION

The world-wide trend in recent years is toward securitization in the lending and capital markets, as well as more complex financial techniques like swaps. However, syndicated loans will still play a dominant role in the merchant banking field as FRNs brings a lower fee income to the banks and pose the danger of bypassing the banks as middlemen eventually. Moreover, FRNs are still in the developing stage in the pre-mature Asian financial markets, and many smaller corporations cannot issue FRNs and thus have to raise funds from the syndication market.

Coming back to Hong Kong, there were two FRN issues by the MTR in 1984 and four swaps transactions in 1985. Although there may not be such a large local demand for funds, more FRNs is expected to be arranged here because of the geographical location in the Asia-Pacific Region, the efficient communications network and the experienced financial expertise from all the major international banks. In fact, from the success of the introduction of the Certificates of Deposits and Commercial Paper, the local investors have increased their literacy toward the securities and other new financial techniques and hence are more acceptable to them. The widening and deepening of the capital market, especially the secondary market trading, is of paramount importance to enhance Hong Kong to foster her position as the third major financial centre in the world.

Finally, in light of the increasing competition in the banking sector and the general slack demand for funds, more varieties of innovative financial vehicles must emerge to attract the borrowers and investors. The growth will most likely accelerate with the pace of modernisation and development of financial markets in China.

Extel Card dated 3rd September, 1984 Appendix 1

Korea Exchange Bank

U.S.$125,000,000

Floating Rate Notes Due 1999

MORGAN GUARANTY LTD BOT INTERNATIONAL (H.K.) LIMITED

BA ASIA LIMITED

BANQUE BRUXELLES LAMBERT S.A.

BT ASIA LIMITED

COMMERZBANK (SOUTH EAST ASIA) LTD.

CRÉDIT LYONNAIS HONGKONG (FINANCE) LIMITED

DAI-ICHI KANGYO FINANCE (HONG KONG) LIMITED

DAIWA EUROPE LIMITED

FIRST INTERSTATE LIMITED

KLEINWORT, BENSON (HONG KONG) LIMITED

KYOWA BANK NEDERLAND N.V.

LLOYDS BANK INTERNATIONAL LIMITED

LTCB ASIA LIMITED

MANUFACTURERS HANOVER ASIA, LIMITED

MITSUBISHI FINANCE INTERNATIONAL LIMITED

MITSUBISHI TRUST AND BANKING CORPORATION (EUROPE) S.A.

MITSUI FINANCE ASIA LIMITED

NATIONAL AUSTRALIA FINANCE (ASIA) LIMITED

NIPPON CREDIT INTERNATIONAL (HONG KONG) LIMITED

ORION ROYAL PACIFIC LIMITED

SAITAMA INTERNATIONAL (HONG KONG) LIMITED

SANWA INTERNATIONAL FINANCE LIMITED

SAUDI INTERNATIONAL BANK
AL-BANK AL-SAUDI AL-ALAMI LIMITED

SINGAPORE NOMURA MERCHANT BANKING LIMITED

STANDARD CHARTERED ASIA LIMITED

THE SUMITOMO TRUST FINANCE (H.K.) LIMITED

WARDLEY LIMITED

THIS CARD IS CIRCULATED TO GIVE DETAILS OF AN ISSUE BY THE BANK AND SHOULD BE RETAINED FOR REFERENCE PURPOSES.

KL — KO49 KOREA EXCHANGE BANK KOR

(Incorporated with limited liability in the Republic of Korea under the Korea Exchange Bank Act of 1966, as amended)

Particulars of an Issue of

U.S.$125,000,000

Floating Rate Notes Due 1999

This card includes particulars given in compliance with the Regulations of the Council of the Stock Exchange of the United Kingdom and Republic of Ireland ("The Stock Exchange in London") for the purpose of giving information with regard to the U.S.$125,000,000 Floating Rate Notes Due 1999 (the "Fifteen Year Notes") and the Three Year Notes (as defined below) of Korea Exchange Bank (the "Bank"). In this card, the term "Notes" means the Fifteen Year Notes and the Three Year Notes (whether issued initially or pursuant to the conversion options contained in the terms and conditions of the Fifteen Year Notes and the Three Year Notes). The Bank confirms that the information relating to the Notes and the Bank which is given herein is true and accurate in all material respects and further confirms, having made all reasonable enquiries, that to the best of its knowledge and belief there are no other facts the omission of which would make any statement in this card in relation to the Notes or the Bank misleading. The Bank accepts responsibility accordingly.

Application has been made to the Council of The Stock Exchange in London for the Notes to be admitted to the Official List.

References herein to "$", "U.S.$" and "dollar" are to United States dollars, and references herein to "W" and "Won" are to the currency of the Republic of Korea.

DESCRIPTION OF THE NOTES

The Fifteen Year Notes will be represented initially by a temporary global bearer note (the "Global Note") without interest coupons, which will be deposited with Morgan Guaranty Trust Company of New York, as common depositary for Morgan Guaranty Trust Company of New York, Brussels office, as operator of the Euro-clear Clearance System ("Euro-clear") and CEDEL S.A. ("CEDEL"), for credit to the accounts designated by the subscribers of the Fifteen Year Notes at Euro-clear or CEDEL. Interests in the Global Note will be transferable in accordance with the rules and procedures for the time being of Euro-clear and CEDEL. The Bank will undertake to exchange interests in the Global Note for definitive Fifteen Year Notes in bearer form, with interest coupons attached, upon the expiry of the period of 90 days after the date of issue of the Global Note upon certification (i) that the beneficial owners of such Fifteen Year Notes are not nationals or residents of the United States of America or its territories or possessions or persons who have acquired such Fifteen Year Notes for resale to such a national or resident, or (ii) in the case of such beneficial owner being a U.S. Bank Branch (as defined in "Subscription and Sale" below), that, inter alia, such U.S. Bank Branch has purchased such Fifteen Year Notes for its own account for investment and without a view to any distribution or other disposition thereof and that, in the event of any disposition of any such Fifteen Year Notes (such disposition not being foreseen or contemplated at the time such certificate is delivered), it will not offer, sell or deliver any such Fifteen Year Notes directly or indirectly except in compliance with the United States Securities Act of 1933. A subscriber or purchaser must exchange his portion of the Global Note for definitive Fifteen Year Notes before interest payments can be received.

The Fifteen Year Notes will be convertible in 1986 and thereafter, at the option of the holders thereof, into floating rate notes each with a three-year maturity and of like principal amount (the "Three Year Notes") on such dates as are specified in, and in accordance with and subject to the terms and conditions of, the Fifteen Year Notes. Each Three Year Note will be convertible into a Fifteen Year Note of like principal amount on such dates as are specified in, and in accordance with and subject to the terms and conditions of, the Three Year Notes.

TERMS AND CONDITIONS OF THE FIFTEEN YEAR NOTES

The issue of the Fifteen Year Notes was authorized by resolutions of the Board of Directors of the Bank passed on 31st August, 1984. Payments of principal and interest in respect of the Fifteen Year Notes will be made pursuant to a fiscal agency agreement (the "Fiscal Agency Agreement") to be entered into between the Bank and Morgan Guaranty Trust Company of New York (the "Fiscal Agent") and the paying agents and transfer agent referred to below. Copies of the Fiscal Agency Agreement (including the forms of the Fifteen Year Notes and the Three Year Notes) will be available for inspection at the specified office of the Fiscal Agent and at the specified office of each of the paying agents for the Notes (the "Paying Agents").

The holders of the Fifteen Year Notes (under this heading being referred to as the "Noteholders") and the holders of the coupons appertaining to the Fifteen Year Notes (under this heading being referred to as "Couponholders") will be deemed to have notice of all the provisions contained in the Fiscal Agency Agreement, which will be binding upon them.

The statements under this heading entitled "Terms and Conditions of the Fifteen Year Notes" are summaries of, and are subject to, the detailed provisions of the Fifteen Year Notes.

1. Status

The Fifteen Year Notes will constitute direct, unconditional and unsecured obligations of the Bank and will rank pari passu among themselves and equally with all other unsecured obligations of the Bank (other than subordinated obligations, if any, and subject to such exceptions as are from time to time applicable under the laws of the Republic of Korea).

2. Form, Denomination and Title

The Fifteen Year Notes will be in bearer form with, at the date of issue, interest coupons (the "Coupons") attached. The Fifteen Year Notes will be in the denominations of U.S.$10,000 and U.S.$250,000. Fifteen Year Notes of one denomination will not be exchangeable for Fifteen Year Notes of the other denomination. The holder of each Coupon (whether or not the Coupon is attached to a Fifteen Year Note) in his capacity as such is subject to and bound by all the provisions contained in the Fifteen Year Notes. Title to the Fifteen Year Notes and the Coupons appertaining thereto shall pass by delivery. The Bank, the Fiscal Agent, the transfer agent referred to in paragraph 5(*b*) below ("the Transfer Agent") and any Paying Agent may deem and treat the bearer of any Fifteen Year Note or any Coupon as the absolute owner thereof (whether or not such Fifteen Year Note or such Coupon shall be overdue and notwithstanding any notice of ownership or writing thereon or notice of any previous loss or theft thereof) for the purpose of receiving payment thereof or on account thereof and for all other purposes.

3. Negative Pledge

So long as any of the Fifteen Year Notes remains outstanding, the Bank will not create or permit to subsist any mortgage, charge, pledge or other security interest upon the whole or any part of its assets, present or future, to secure any indebtedness, or to secure any guarantee of indebtedness, unless the Fifteen Year Notes shall be secured equally and rateably therewith, except that the Bank may create or permit to arise or subsist:–

(a) any encumbrance over promissory notes or other commercial paper discounted or otherwise provided as security to or issued by the Bank where such encumbrance is created in favour of the Bank of Korea in the normal operation of its discount facilities or its facilities for the funding of loans by the Bank to customers of the Bank; or

(b) any encumbrance over any immovable property owned by the Bank as security for the repayment by the Bank to a tenant of that property of any key money paid by such tenant to the Bank upon taking a tenancy or lease of that property; or

(c) any statutory liens arising in the ordinary course of the Bank's business and not in connection with the borrowing or raising of money; or

(d) any encumbrance arising or preference given under Korean law, applicable generally to corporations established under Korean law, by virtue of a failure by the Bank to meet an obligation, provided that such encumbrance shall not be permitted to subsist for more than thirty (30) days; or

(e) any encumbrance over any asset purchased by the Bank (or documents of title thereto) as security for the unpaid balance of the purchase price thereof.

4. Interest

(a) Period of Accrual of Interest

The Fifteen Year Notes will bear interest from the date of issue of the temporary Global Note (the "Issue Date") which is expected to be 12th September, 1984 and interest on each Fifteen Year Note will cease to accrue as from the due date for redemption thereof unless, upon due presentation of any Fifteen Year Note, payment of principal is improperly withheld or refused. In such event, interest will continue to accrue on such Fifteen Year Note (as well after as before any judgment) up to and including the date on which payment in full of the principal thereof is made or (if earlier) the date on which, the funds for the payment in full of the principal thereof having been received in New York City by the Fiscal agent, notice to that effect shall have been duly given to such Noteholder.

(b) Interest Payment Dates and Interest Periods

Interest on the Fifteen Year Notes will be payable on each date ("Interest Payment Date") which (save as mentioned below) falls six months after the preceding Interest Payment Date or, in the case of the first Interest Payment Date, after the Issue Date. If any Interest Payment Date would otherwise fall on a day which is not a business day (as defined below), it shall be postponed to the next day which is a business day unless it would thereby fall into the next calendar month, in which event (i) the Interest Payment Date shall be brought forward to the immediately preceding business day and (ii) thereafter each Interest Payment Date shall be the last business day of the sixth month after the month in which the preceding Interest Payment Date shall have fallen. The period from and including the Issue Date to but excluding the first Interest Payment Date and each successive period from and including an Interest Payment Date to but excluding the next succeeding Interest Payment Date is herein called an "Interest Period". As used in this paragraph, "business day" means a day upon which banks are open for business in each of London and New York City.

(c) Coupons

Interest due on each Interest Payment Date will be paid against presentation and surrender of the Coupons attached on issue to the Fifteen Year Notes as they severally mature, in accordance with paragraph 6 below.

(d) Rate of Interest

For the purpose of calculating the rate of interest payable in respect of the Fifteen Year Notes, the Bank will enter into an agreement (the "Agent Bank Agreement") with Morgan Guaranty Trust Company of New York (the "Agent Bank"). The rate of interest payable from time to time in respect of the Fifteen Year Notes (the "Rate of Interest") and the Coupon Amount (as defined below) will be determined on the basis of the provisions set out below:–

(i) On each "Interest Determination Date", namely the second business day prior to the commencement of the Interest Period for which such rate will apply, the Agent Bank will request the principal London offices of each of International Westminster Bank p.l.c., Midland Bank plc, Bankers Trust Company and Commerzbank A.G. (the "Reference Banks") to provide the Agent Bank with their offered quotations to leading banks for dollar deposits in the London interbank market for the Interest Period concerned as at 11.00 a.m. (London time) on the Interest Determination Date in question. The Rate of Interest for such Interest Period shall, subject as provided below, be three-eighths of one per cent. (⅜%) per annum above the arithmetic average (rounded upwards if necessary to the nearest one-sixteenth of one per cent. (1/16%) of such offered quotations as determined by the Agent Bank.

(ii) If on any Interest Determination Date two or three only of the Reference Banks provide such quotations, the Rate of Interest for the relevant Interest Period shall, subject as provided below, be determined on the basis of the offered quotations of those Reference Banks providing such quotations.

(iii) If on any Interest Determination Date one only or none of the Reference Banks provides such a quotation, then the applicable Rate of Interest for the relevant Interest Period shall, subject as provided below, be the Reserve Interest Rate. The "Reserve Interest Rate" shall be the rate per annum which the Agent Bank determines to be either (i) three-eighths of one per cent. (⅜%) per annum above the arithmetic average (rounded upwards if necessary to the nearest one-sixteenth of one per cent. (1/16%)) of the dollar lending rates which leading banks in New York City (selected by the Agent Bank) are quoting, on the relevant Interest Determination Date, for the relevant Interest Period, to the Reference Banks or those of them (being at least two in number) to which such quotations are in the opinion of the Agent Bank being so made or (ii) in the event that the Agent Bank can determine no such arithmetic average, three-eighths of one per cent. (⅜%) per annum above the lowest dollar lending rates which leading banks in New York City (selected by the Agent Bank) quote on the relevant Interest Determination Date to leading banks which have their head offices in Europe for the relevant Interest Period, provided that if the banks selected as aforesaid by the Agent Bank are not quoting as mentioned above, then the Rate of Interest shall, subject as provided below, be the Rate of Interest in effect on the relevant Interest Determination Date.

(iv) In no event shall the Rate of Interest be less than five and one-half of one per cent. (5½%) per annum.

(v) The amount of interest payable on presentation and surrender of a Coupon maturing on a particular Interest Payment Date (the "Coupon Amount") shall be calculated by the Agent Bank applying the Rate of Interest to the principal amount of the Fifteen Year Note to which such Coupon appertains, multiplying such sum by the actual number of days in the Interest Period concerned divided by 360 and rounding the resultant figure to the nearest cent (half a cent being rounded upwards).

(e) *Publication of Rate of Interest*

The Agent Bank shall cause the Rate of Interest and the Coupon Amount for each Interest Period, together with the relative Interest Payment Date, to be notified to The Stock Exchange in London so long as the Fifteen Year Notes are listed on such exchange and to be published in accordance with the provisions of paragraph 12 below as soon as possible after their determination but in no event later than the fourth business day following the relevant Interest Determination Date.

(f) *Subsequent Adjustments*

The Agent Bank may make an appropriate adjustment to the Interest Payment Date and the Coupon Amount in the event that the relevant Interest Period ends on a date other than that used in the calculation of the Rate of Interest and the Coupon Amount.

(g) *Notifications, etc.*

All notifications, opinions, determinations, certificates, calculations, quotations and decisions given, expressed, made or obtained for the purposes of the provisions summarised in this paragraph 4, whether by the Reference Banks (or any of them) or the Agent Bank shall (in the absence of manifest error, gross negligence or wilful misconduct) be binding on the Bank, the Reference Banks, the Agent Bank, the Fiscal Agent, the Paying Agents, the Transfer Agent and all Noteholders and Couponholders and (subject as aforesaid) no liability to the Noteholders or the Couponholders or any of them shall attach to the Reference Banks or the Agent Bank or the Transfer Agent or any of them, in connection with the exercise or non-exercise by any of them of their powers, duties and discretions.

(h) *Reference Banks and Agent Bank*

The Bank will ensure that so long as any of the Fifteen Year Notes remains outstanding there shall at all times be four Reference Banks and an Agent Bank for the purposes of the Fifteen Year Notes. In the event of any such bank being unable or unwilling to continue to act through its specified office as a Reference Bank or the Agent Bank, as the case may be, or, in the case of the Agent Bank, its failing duly to determine the Rate of Interest and the Coupon Amount for any Interest Period, the Bank shall forthwith appoint the London office of some other leading bank engaged in the Eurodollar market to act as Reference Bank or, as the case may be, Agent Bank in its place. In addition, the Bank may terminate the appointment of the Agent Bank and appoint another bank as aforesaid to act in its place. The Agent

Bank may not resign its duties nor may it be removed from office without a successor having been appointed as aforesaid.

5. Redemption, Conversion and Purchase

(a) Final Redemption

Unless previously redeemed or converted or purchased and cancelled in accordance with this paragraph, the Fifteen Year Notes will be redeemed at their principal amount on the Interest Payment Date falling in September, 1999.

(b) Conversion

The holder of each Fifteen Year Note may not less than 75 nor more than 120 days prior to any Interest Payment Date falling in September, commencing with the Interest Payment Date falling in September, 1986, submit to the Transfer Agent a notice in the form available from the Transfer Agent or any Paying Agent irrevocably requiring the conversion of such Fifteen Year Note into a floating rate note with a three-year maturity in the form set out in the Fiscal Agency Agreement (a "Three Year Note"). The Bank may instruct the Transfer Agent to accept a notice submitted less than 75 but not less than 60 days prior to such Interest Payment Date but such instruction shall be at the absolute discretion of the Bank. Each such notice shall be accompanied by the relative Fifteen Year Note or Notes, together with all unmatured Coupons appertaining thereto other than the Coupon(s) falling due on such Interest Payment Date, which may be presented for payment on or after such Interest Payment Date in the manner described in paragraph 6 below. Subject to the right of the Bank to redeem the relevant Fifteen Year Note on such Interest Payment Date contained in sub-paragraph (*c*) of this paragraph, the Bank shall cause the Transfer Agent to issue to the holder of each Fifteen Year Note in respect of which such a notice is duly given, on the relevant Interest Payment Date, a Three Year Note at an issue price equal to the principal amount thereof, such price to be discharged by application of the principal sum repayable in respect of such Fifteen Year Note. Pending issue of such Three Year Note, such Fifteen Year Note, together with any other Fifteen Year Notes submitted under this sub-paragraph (*b*) by the same and/or other Noteholders for conversion on the same Interest Payment Date, shall be credited by the Transfer Agent to a blocked account of all such Noteholders and no such Fifteen Year Note may be withdrawn therefrom without the consent of the Bank. Each Three Year Note to be issued shall be in bearer form, shall be of the same principal amount as the Fifteen Year Note in respect of which it is issued, shall be deemed to have been issued on the relevant Interest Payment Date, shall mature on the Interest Payment Date falling on or closest to the third anniversary of the relevant Interest Payment Date and shall on issue have attached thereto Coupons for payment of interest on such Three Year Note falling due on Interest Payment Dates following the relevant Interest Payment Date up to and including the maturity date. Each Three Year Note to be issued shall be made available for collection at the specified office of the Transfer Agent or shall, if the relative notice so requires, be dispatched by the Transfer Agent, uninsured and at the risk of the Noteholder concerned, to an address outside the United States of America, its territories or possessions. Fifteen Year Notes so submitted shall be repaid, and Three Year Notes to be issued as mentioned above shall be issued, without service charges and without any payment by the Noteholder of any stamp, issue, documentary or other similar taxes, duties or governmental charges.

(c) Redemption at the Option of the Bank

Having given not less than 30 days' nor more than 45 days' notice to the Noteholders, the Bank may redeem all or, from time to time, some (being U.S.$5,000,000 in principal amount or an integral multiple thereof) of the Fifteen Year Notes on any Interest Payment Date falling in or after September, 1986 at their principal amount.

Where partial redemptions are to be effected under this sub-paragraph (*c*), the Fifteen Year Notes to be redeemed will be selected by the Fiscal Agent by drawing individually by lot in London, not less than 30 days before the date fixed for redemption, and notice of the serial numbers of the Fifteen Year Notes so drawn and of the date fixed for redemption will be given to the Noteholders in accordance with paragraph 12 below not less than 30 days before the date fixed for redemption.

(d) Redemption for Taxation Reasons

Having given not less than 30 days' nor more than 45 days' notice to the Noteholders, the Bank may on any Interest Payment Date redeem all, but not some only, of the Fifteen Year Notes then outstanding at their principal amount if the Bank has been or would, on the occassion of the next payment due in respect of the Fifteen Year Notes, be required as a result of any change in the tax laws or treaties of the Republic of Korea or in the administration or interpretation thereof to pay additional amounts or make any reimbursement in accordance with the provisions of paragraph 7 below.

(e) Optional Purchase

The Bank or any of its subsidiaries may at any time purchase beneficially or procure others to purchase beneficially for its account Fifteen Year Notes in the open market or otherwise at any price, except that on a purchase by private treaty the price (exclusive of expenses and accrued interest) shall not exceed 140 per cent. of the mean of the nominal quotations of the Fifteen Year Notes (based on The Stock Exchange Daily Official List) on The Stock Exchange in London (or such other stock exchange as may be the principal stock exchange on which the Fifteen Year Notes are listed) at the close of business on the last business day preceding the date of purchase.

(f) Cancellation

All Fifteen Year Notes redeemed or converted into Three Year Notes or purchased pursuant to this paragraph will be forthwith cancelled (together with all unmatured Coupons appertaining thereto) and may not be reissued or resold.

6. Payments

(a) Payments of principal in respect of Fifteen Year Notes will be made against surrender of Fifteen Year Notes at the specified office of the Fiscal Agent or any Paying Agent by dollar cheque drawn on, or by transfer to a dollar account maintained by the payee with, a bank in New York City. Payments of interest in respect of Fifteen Year Notes will be made against surrender of the appropriate Coupons at any specified office of the Fiscal Agent or any Paying Agent in the manner provided in the preceding sentence, provided that no payments of interest in respect of Fifteen Year Notes will be made at any specified office of the Fiscal Agent or any Paying Agent in the United States of America or any of its territories or possessions. Payments of principal of and interest in respect of the Fifteen Year Notes are subject in all cases to any fiscal or other laws and regulations applicable thereto, but without prejudice to the provisions of paragraph 7 below.

(b) The initial Fiscal Agent and Paying Agents and their initial specified offices are listed at the foot hereof. The Bank reserves the right at any time to vary or terminate the appointment of the Fiscal Agent, provided that there will at all times be a Fiscal Agent, and may terminate the appointment of any Paying Agent and appoint additional or other Paying Agents. The Bank will in all events maintain a Paying Agent in New York City and, so long as the Fifteen Year Notes are listed on The Stock Exchange in London, a Paying Agent in London. Notice of any change in or addition to the Fiscal Agent, the Paying Agents or their specified offices will be published in accordance with paragraph 12 below.

(c) In the case of the redemption of any Fifteen Year Note prior to maturity or the conversion of any Fifteen Year Note into a Three Year Note, the Fifteen Year Note should be presented for payment or, as the case may be, lodged for conversion together with all unmatured Coupons (save, in the case of a Fifteen Year Note lodged for conversion, for the Coupon maturing on the Interest Payment Date on which such conversion is to take place), failing which payment of principal will only be made against the Noteholder giving such indemnity in respect of the missing unmatured Coupons as the Bank may require. Upon the date upon which any Fifteen Year Note becomes due and payable or upon any Fifteen Year Note being purchased and cancelled pursuant to paragraph 5(*f*) above, the unmatured Coupons (if any) appertaining thereto shall become void and no payment shall be due in respect thereof.

(d) If the due date for redemption of any Fifteen Year Note is not an Interest Payment Date, the interest accrued from the preceding Interest Payment Date (or from the Issue Date, as the case may be) shall be payable only against surrender of the relative Fifteen Year Note.

7. Taxation

All payments of principal and interest in respect of the Fifteen Year Notes by the Bank will be made without deduction or withholding for or on account of any present or future taxes or duties of whatever nature levied by or on behalf of the Republic of Korea or any authority thereof or therein, unless deduction or withholding of such taxes or duties is compelled by law. In that event the Bank will pay such additional amounts by way of principal or interest as will result in the payment to the Noteholders or Couponholders of the amounts which would otherwise have been receivable in respect of principal and interest, except that no such additional amount shall be payable in respect of any Fifteen Year Note or Coupon presented for payment:–

(a) by or on behalf of a holder who is subject to such taxes or duties in respect of such Fifteen Year Note or Coupon by reason of his being connected with the Republic of Korea otherwise than merely by holding such Fifteen Year Note or Coupon or receiving principal or interest in respect thereof; or

(b) more than 30 days after the relevant date except to the extent that the holder thereof would have been entitled to such additional payment on presenting the same for payment on the last day of such 30-day period. For this purpose the "relevant date" in relation to any Fifteen Year Note or Coupon means:–

  (i) the due date for payment thereof; or

  (ii) (if the full amount of the moneys payable on such due date has not been received in New York City by the Fiscal Agent on or prior to such due date) the date on which, the full amount of such moneys having been so received, notice to that effect is duly given to the Noteholders and the Couponholders in accordance with paragraph 12 below.

References to principal and/or interest in respect of the Fifteen Year Notes shall be deemed also to refer to any additional amounts which may be payable under this paragraph.

8. Events of Default

If any of the following events ("Events of Default") shall occur:–

(a) default being made for a period of seven days in the payment of any principal moneys in respect of any of the Fifteen Year Notes or Three Year Notes when and as the same ought to be paid in accordance with the terms thereof; or

(b) default being made for a period of fifteen days in the payment of any interest in respect of any of the Fifteen Year Notes or Three Year Notes when and as the same ought to be paid in accordance with the terms thereof; or

(c) the Bank failing duly to perform or observe any covenant, condition or provision contained in the Fifteen Year Notes or Three Year Notes (other than any obligation for the payment of any principal or interest in respect of the Fifteen Year Notes or Three Year Notes) and such failure not being remedied within 30 days following the date on which written notice of such failure, requiring the Bank to remedy the same, shall first have been given to the Bank by any Noteholder; or

(d) any Indebtedness of the Bank in the aggregate principal amount of U.S.$1,000,000 or more either (i) becoming due and payable prior to the due date for payment thereof by reason of default by the Bank or (ii) not being repaid at maturity as extended by the period of grace, if any, applicable thereto, or any guarantee or indemnity given by the Bank in respect of Indebtedness of any other person not being honoured when due and called. For the purposes of this paragraph "Indebtedness" means any obligation for the payment or repayment of money borrowed or raised by whatever means (including acceptances, deposits and leasing) or for the deferred purchase price of assets or services; or

(e) the Republic of Korea or any competent authority thereof declaring a moratorium on the payment of any borrowed moneys (including obligations arising under guarantees) by it or by any governmental agency or authority thereof or the Republic of Korea or any competent authority or governmental agency thereof becoming liable to repay prematurely any sums in respect of such borrowed moneys (including obligations arising under guarantees) as a result of a default under, or breach of the terms applicable to, such borrowed moneys obligations, or the Republic of Korea ceasing to be a member in good standing of the International Monetary Fund or the International Bank for Reconstruction and Development or the international monetary reserves of the Republic of Korea becoming subject to any lien, charge, mortgage, encumbrance or other security interest or any segregation or other preferential arrangement (whether or not constituting a security interest) for the benefit of any creditor or class of creditors; or

(f) the Republic of Korea and the Bank of Korea ceasing to own and control (directly or indirectly) the Bank or for any reason failing to provide the financial support to the Bank stipulated as at the Issue Date by Article 23 of the Korea Exchange Bank Act of 1966, as amended; or

(g) the Bank being adjudicated or found bankrupt or insolvent or any order being made by a competent court or administrative agency or any resolution being passed by the Bank to apply for judicial composition proceedings with its creditors or for the appointment of a receiver or trustee or other similar official in insolvency proceedings in relation to the Bank or a substantial part of its assets or the Bank being wound up or dissolved or the Bank ceasing to carry on the whole or substantially the whole of its business,

then the holder of any Fifteen Year Note may by giving written notice to the Bank at the specified office of the Fiscal Agent and without presentment, demand, protest or other notice of any kind, all of which the Bank hereby expressly waives, declare such Fifteen Year Note to be immediately due and payable, whereupon such Fifteen Year Note shall become immediately due and payable. Any such notice shall specify the serial number(s) of the Fifteen Year Note(s) concerned and shall be effective only upon receipt thereof.

If any Fifteen Year Note shall become due and payable interest shall accrue thereon until the date upon which, the principal amount of the relevant Fifteen Year Note having been duly paid to the Fiscal Agent, notice thereof is duly given to the holder of such Fifteen Year Note. The Rate of Interest payable shall be calculated at six-monthly intervals (the first of which shall commence on the expiry of the Interest Period during which such Fifteen Year Note becomes due and payable) mutatis mutandis in accordance with the provisions of paragraph 4 above, except that the Rate of Interest and Coupon Amount need not be published.

The Bank shall fully indemnify each Noteholder from and against any reasonable costs, expenses, liabilities and losses which such Noteholder may suffer or incur as a direct result of the occurrence of any Event of Default and/or as a result of such Noteholder's Fifteen Year Note thereby being declared immediately due and payable (including, but without limitation, any expenses incurred in connection with legal proceedings to enforce repayment of such Fifteen Year Note).

9. Prescription

Each Fifteen Year Note and Coupon will become void unless presented for payment within five years from the relevant date, as defined in paragraph 7 above, for payment thereof.

10. Meetings of Noteholders and holders of Three Year Notes

Meetings of Noteholders and holders of Three Year Notes may be convened, which will have the power, inter alia, to sanction by an Extraordinary Resolution, proposed by the Bank, any compromise of, or arrangement in respect of, the rights of the Noteholders and the holders of Three Year Notes, any proposal for exchange of the Fifteen Year Notes and Three Year Notes into other obligations or securities of the Bank or its successors, and any modifications of the terms and conditions of the Notes, provided, however, that the consent of each affected Noteholder and holder of Three Year Notes shall be required for (i) any reduction or cancellation of any amount payable in respect of the Fifteen Year Notes or Three Year Notes, (ii) any reduction in the rate of interest payable in respect of the Fifteen Year Notes or Three Year Notes, (iii) a postponement of the due date for any payment of principal or interest in respect of the Fifteen Year Notes or Three Year Notes, (iv) any variation of the currency in which payments in respect of the Fifteen Year Notes or Three Year Notes are to be made, or (v) any amendment to the majorities required for passing resolutions at meetings of Noteholders and holders of Three Year Notes or the requirements as to unanimous consent by each affected Noteholder and holder of Three Year Notes. The provisions for the convening and holding of meetings of Noteholders and holders of Three Year Notes will be set out in a schedule to the Fiscal Agency Agreement. On all matters raised at any meeting the Fifteen Year Notes and the Three Year Notes shall be treated together as one class.

As used herein "Extraordinary Resolution" means a resolution passed, at a meeting of the Noteholders and the holders of Three Year Notes duly convened and held in accordance with the said provisions, by not less than threequarters of the votes cast thereon. At any meeting every Noteholder and holder of Three Year Notes who is entitled to attend such meeting and who (being an individual) is present in person or (being a corporation) is present by its duly authorised representative or by one of its officers as its proxy shall have one vote on a show of hands. On a poll every Noteholder and holder of Three Year Notes who is entitled to attend such meeting and who is present in person or by proxy shall have one vote in respect of each U.S.$10,000 in outstanding principal amount of the Fifteen Year Notes or, as the case may be, Three Year Notes held by him.

11. Replacement of Fifteen Year Notes and Coupons

If a Fifteen Year Note or Coupon is mutilated, defaced, lost, stolen or destroyed it may, at the discretion of the Bank, be replaced at the specified office of the Fiscal Agent in New York or the Paying Agent in London on payment of such costs as may be incurred in connection therewith and on such terms as to evidence and indemnity as the Bank may require. Mutilated or defaced Fifteen Year Notes or Coupons must be surrendered before replacements will be issued.

12. Notices

All notices to the Noteholders will be valid if published in one leading London daily newspaper or, if this is not at any time practicable, in at least one leading daily newspaper of general circulation in Europe. It is expected that publications of notices will normally be made in the Financial Times in London.

13. Exchange Rate Indemnity

If a judgment or order is given by a court or tribunal of competent jurisdiction for the payment of any amounts owing in respect of the Fifteen Year Notes or the Coupons to the holders thereof and such judgment or order is expressed in a currency other than dollars, the Bank shall indemnify and hold each Noteholder and Couponholder harmless against any deficiency arising or resulting therefrom (including, without limitation, by reason of any variation in rates of exchange as between the currency in which such judgment or order is given and dollars).

14. No Waiver, Remedies Cumulative

No failure to exercise, and no delay in exercising, on the part of the holder of any Fifteen Year Note or Coupon, any right with respect thereto shall operate as a waiver thereof, nor shall any single or partial exercise thereof preclude any other or future exercise thereof or the exercise of any other right. Rights pursuant to the terms of the Fifteen Year Notes shall be in addition to all other rights provided by law. No notice or demand given in any case shall constitute a waiver of rights to take other action in the same, similar or other instances without such notice or demand.

15. Fiscal Agent, Transfer Agent, Paying Agents and Agent Bank

(a) In acting under the Fiscal Agency Agreement and the Agent Bank Agreement, the Fiscal Agent, the Paying Agents, the Transfer Agent and the Agent Bank respectively are acting solely as agents of the Bank and do not assume any obligation or relationship of agency or trust for or with the holders of the Fifteen Year Notes or Coupons, except that (without affecting the obligations of the Bank to the holders of the Fifteen Year Notes to repay the Fifteen Year Notes in accordance with their terms) any funds received by the Fiscal Agent for the payment of the principal of, or interest in respect of, the Fifteen Year Notes shall be held by it in trust for the Noteholders until the expiry of the period of prescription specified in paragraph 9 above.

(b) The Bank and the Fiscal Agent or (as the case may be) the Agent Bank may, without the consent of any Paying Agent or any Noteholder or Couponholder, agree to any modification of the provisions of the Fiscal Agency Agreement or (as the case may be) the Agent Bank Agreement which, in the reasonable opinion of the Bank and the Fiscal Agent or (as the case may be) the Agent Bank, is not materially prejudicial to the interests of any Noteholder or Couponholder or to any modification thereof which is of a formal, minor or technical nature or is made to correct a manifest error. Any such modification shall be binding on the Noteholders and the Couponholders and (in the case of the Fiscal Agency Agreement) the Paying Agents and notice of any such modification shall (unless the Fiscal Agent or (as the case may be) the Agent Bank agrees otherwise) be given to the Noteholders in accordance with paragraph 12 above as soon as practicable thereafter.

16. Definitions

For the purposes of the terms and conditions of the Fifteen Year Notes and of this summary thereof:–

(a) "outstanding" means, in relation to the Fifteen Year Notes and/or the Three Year Notes (as the case may be), all the Fifteen Year Notes and/or the Three Year Notes (as the case may be) other than, in each case, (i) those which have been redeemed in accordance with their terms and conditions, (ii) those in respect of which the date for redemption in accordance with their terms and conditions has occurred and the principal in respect whereof and all interest payable under the said terms and conditions in respect thereof have been duly paid to the Fiscal Agent in the manner provided in the Fiscal Agency Agreement and remain available for payment against surrender of the relevant Fifteen Year Notes and/or the Three Year Notes and/or Coupons, as the case may be, (iii) those which have been purchased in accordance with paragraph 5(*e*) above and cancelled, (iv) those which have become void under paragraph 9 above, (v) those Fifteen Year Notes which have been converted into Three Year Notes and in respect of which Three Year Notes have been issued pursuant to their terms and conditions, (vi) those Three Year Notes which have been converted into Fifteen Year Notes and in respect of which Fifteen Year Notes have been issued pursuant to their terms and conditions and (vii) those mutilated or defaced Fifteen Year Notes or Three Year Notes, as the case may be, in respect of which replacement notes have been issued pursuant to their Terms and Conditions; and

(b) "redeem" shall include "repay" and vice versa and "redeem", "redemption" and "repay", "repayable" and "repayment" shall be construed accordingly.

17. Governing Law

The Fifteen Year Notes, the Coupons and the Fiscal Agency Agreement will be governed by and construed in accordance with the law of England. The Bank will submit to the non-exclusive jurisdiction of the courts of the Republic of Korea, the courts of England and the courts of the State of New York and the United States Federal Courts in the State of New York in relation to the Fiscal Agency Agreement, the Fifteen Year Notes and the Coupons, waive any rights of sovereign immunity and agree to appoint an agent for service of process, as provided in the Fifteen Year Notes and the Fiscal Agency Agreement.

TERMS AND CONDITIONS OF THE THREE YEAR NOTES

The issue of the Three Year Notes was authorized by resolutions of the Board of Directors of the Bank passed on 31st August, 1984. Payments of principal and interest in respect of the Three Year Notes will be made pursuant to the Fiscal Agency Agreement. Copies of the Fiscal Agency Agreement (including the forms of the Three Year Notes and the Fifteen Year Notes) will be available for inspection at the specified office of the Fiscal Agent and at the specified office of each of the Paying Agents.

The holders of the Three Year Notes (under this heading being referred to as "Noteholders") and the holders of the coupons appertaining to the Three Year Notes (under this heading being referred to as "Couponholders") will be deemed to have notice of all the provisions contained in the Fiscal Agency Agreement, which will be binding upon them.

The statements under this heading entitled "Terms and Conditions of the Three Year Notes" are summaries of, and are subject to, the detailed provisions of the Three Year Notes.

1. Status

The Three Year Notes will constitute direct, unconditional and unsecured obligations of the Bank and will rank pari passu among themselves and equally with all other unsecured obligations of the Bank (other than subordinated obligations, if any, and subject to such exceptions as are from time to time applicable under the laws of the Republic of Korea).

2. Form, Denomination and Title

The Three Year Notes will be in bearer form with, at the date of issue, interest coupons (the "Coupons") attached. The Three Year Notes will be in the denominations of U.S.$10,000 and U.S.$250,000. Three Year Notes of one denomination will not be exchangeable for Three Year Notes of the other denomination. The holder of each Coupon (whether or not the Coupon is attached to a Three Year Note) in his capacity as such is subject to and bound by all the provisions contained in the Three Year Notes. Title to the Three Year Notes and the Coupons appertaining thereto shall pass by delivery. The Bank, the Fiscal Agent, the transfer agent referred to in paragraph 5(*b*) below ("the Transfer Agent") and any Paying Agent may deem and treat the bearer of any Three Year Note or any Coupon as the absolute owner thereof (whether or not such Three Year Note or such Coupon shall be overdue and notwithstanding any notice of ownership or writing thereon or notice of any previous loss or theft thereof) for the purpose of receiving payment thereof or on account thereof and for all other purposes.

3. Negative Pledge

So long as any of the Three Year Notes remains outstanding, the Bank will not create or permit to subsist any mortgage, charge, pledge or other security interest upon the whole or any part of its assets, present or future, to secure any indebtedness, or to secure any guarantee of indebtedness, unless the Three Year Notes shall be secured equally and rateably therewith, except that the Bank may create or permit to arise or subsist:–

(a) any encumbrance over promissory notes or other commercial paper discounted or otherwise provided as security to or issued by the Bank where such encumbrance is created in favour of the Bank of Korea in the normal operation of its discount facilities or its facilities for the funding of loans by the Bank to customers of the Bank; or

(b) any encumbrance over any immovable property owned by the Bank as security for the repayment by the Bank to a tenant of that property of any key money paid by such tenant to the Bank upon taking a tenancy or lease of that property; or

(c) any statutory liens arising in the ordinary course of the Bank's business and not in connection with the borrowing or raising of money; or

(d) any encumbrance arising or preference given under Korean law, applicable generally to corporations established under Korean law, by virtue of a failure by the Bank to meet an obligation, provided that such encumbrance shall not be permitted to subsist for more than thirty (30) days; or

(e) any encumbrance over any asset purchased by the Bank (or documents of title thereto) as security for the unpaid balance of the purchase price thereof.

4. Interest

(a) Period of Accrual of Interest

Each Three Year Note will bear interest from its date of issue in accordance with the terms and conditions of the Fifteen Year Notes, which shall be a September Interest Payment Date for the Fifteen Year Notes (its "Issue Date") and interest on each Three Year Note will cease to accrue as from the due date for redemption thereof unless, upon due presentation of any Three Year Note, payment of principal is improperly withheld or refused. In such event, interest will continue to accrue on such Three Year Note (as well after as before any judgement) up to and including the date on which payment in full of the principal thereof is made or (if earlier) the date on which, the funds for the payment in full of the principal thereof having been received in New York City by the Fiscal Agent, notice to that effect shall have been duly given to such Noteholder.

(b) Interest Payment Dates and Interest Periods

Interest on each Three Year Note will be payable on each date ("Interest Payment Date") which (save as mentioned below) falls six months after the preceding Interest Payment Date or, in the case of the first Interest Payment Date, after its Issue Date. If any Interest Payment Date would otherwise fall on a day which is not a business day (as defined below), it shall be postponed to the next day which is a business day unless it would thereby fall into the next calendar month, in which event (i) the Interest Payment Date shall be brought forward to the immediately preceding business day and (ii) thereafter each Interest Payment Date shall be the last business day of the sixth month after the month in which the preceding Interest Payment Date shall have fallen. The period from and including the Issue Date to but excluding the first Interest Payment Date and each successive period from and including an Interest Payment Date to but excluding the next succeeding Interest Payment Date is herein called an "Interest Period". As used in this paragraph "business day" means a day upon which banks are open for business in each of London and New York City.

(c) Coupons

Interest due on each Interest Payment Date will be paid against presentation and surrender of the Coupons attached on issue to the Three Year Notes as they severally mature, in accordance with paragraph 6 below.

(d) Rate of Interest

For the purpose of calculating the rate of interest payable in respect of the Three Year Notes, the Bank will enter into an agreement (the "Agent Bank Agreement") with Morgan Guaranty Trust Company of New York (the "Agent Bank"). The rate of interest payable from time to time in respect of the Three Year Notes (the "Rate of Interest") and the Coupon Amount (as defined below) will be determined on the basis of the provisions set out below:–

(i) On each "Interest Determination Date", namely the second business day prior to the commencement of the Interest Period for which such rate will apply, the Agent Bank will request the principal London offices of each of International Westminster Bank p.l.c., Midland Bank plc, Bankers Trust Company and Commerzbank A.G. (the "Reference Banks") to provide the Agent Bank with their offered quotations to leading banks for dollar deposits in the London interbank market for the Interest Period concerned as at 11.00 a.m. (London time) on the Interest Determination Date in question. The Rate of Interest for such Interest Period shall, subject as provided below, be one-eighth of one per cent. (⅛%) per annum above the arithmetic average (rounded upwards if necessary to the nearest one-sixteenth of one per cent. (1/16%)) of such offered quotations as determined by the Agent Bank.

(ii) If on any Interest Determination Date two or three only of the Reference Banks provide such quotations, the Rate of Interest for the relevant Interest Period shall, subject as provided below, be determined on the basis of the offered quotations of those Reference Banks providing such quotations.

(iii) If on any Interest Determination Date one only or none of the Reference Banks provides such a quotation, then the applicable Rate of Interest for the relevant Interest Period shall, subject as provided below, be the Reserve Interest Rate. The "Reserve Interest Rate" shall be the rate per annum which the Agent Bank determines to be either (i) one-eighth of one per cent. (⅛%) per annum above the arithmetic average (rounded upwards if necessary to the nearest one-sixteenth of one per cent. (1/16%)) of the dollar lending rates which leading banks in New York City (selected by the Agent Bank) are quoting, on the relevant Interest Determination Date, for the relevant Interest Period, to the Reference Banks or those of them (being at least two in number) to which such quotations are in the opinion of the Agent Bank being so made or (ii) in the event that the Agent Bank can determine no such arithmetic average, one-eighth of one per cent. (⅛%) per annum above the lowest dollar lending rates which leading banks in New York City (selected by the Agent Bank) quote on the relevant Interest Determination Date to leading banks which have their head offices in Europe for the relevant Interest Period, provided that if the banks selected as aforesaid by the Agent Bank are not quoting as mentioned above, then the Rate of Interest shall, subject as provided below, be the Rate of Interest in effect on the relevant Interest Determination Date.

(iv) In no event shall the Rate of Interest be less than five and one-half of one per cent. (5½%) per annum.

(v) The amount of interest payable on presentation and surrender of a Coupon maturing on a particular Interest Payment Date (the "Coupon Amount") shall be calculated by the Agent Bank applying the Rate of Interest to the principal amount of the Three Year Notes to which such Coupon appertains, multiplying such sum by the actual number of days in the Interest Period concerned divided by 360 and rounding the resultant figure to the nearest cent (half a cent being rounded upwards).

(e) Publication of Rate of Interest

The Agent Bank shall cause the Rate of Interest and the Coupon Amount for each Interest Period, together with the relative Interest Payment Date, to be notified to The Stock Exchange in London so long as the Three Year Notes are listed on such exchange and to be published in accordance with the provisions of paragraph 12 below as soon as possible after their determination but in no event later than the fourth business day following the relevant Interest Determination Date.

(f) Subsequent Adjustments

The Agent Bank may make an appropriate adjustment to the Interest Payment Date and the Coupon Amount in the event that the relevant Interest Period ends on a date other than that used in the calculation of the Rate of Interest and the Coupon Amount.

(g) Notifications, etc.

All notifications, opinions, determinations, certificates, calculations, quotations and decisions given, expressed, made or obtained for the purposes of the provisions summarised in this paragraph 4, whether by the Reference Banks (or any of them) or the Agent Bank shall (in the absence of manifest error, gross negligence or wilful misconduct) be binding on the Bank, the Reference Banks, the Agent Bank, the Fiscal Agent, the Paying Agents, the Transfer Agent and all Noteholders and Couponholders and (subject as aforesaid) no liability to the Noteholders or the Couponholders or any of them shall attach to the Reference Banks or the Agent Bank or the Transfer Agent or any of them, in connection with the exercise or non-exercise by any of them of their powers, duties and discretions.

(h) Reference Banks and Agent Bank

The Bank will ensure that so long as any of the Three Year Notes remains outstanding there shall at all times be four Reference Banks and an Agent Bank for the purposes of the Three Year Notes. In the event of any such bank being unable or unwilling to continue to act through its specified office as a Reference Bank or the Agent Bank, as the case may be, or, in the case of the Agent Bank, its failing duly to determine the Rate of Interest and the Coupon Amount for any Interest Period, the Bank shall forthwith appoint the London office of some other leading bank engaged in the Eurodollar market to act as Reference Bank or, as the case may be, Agent Bank in its place. In addition, the Bank may terminate the appointment of the Agent Bank and appoint another bank as aforesaid to act in its place. The Agent Bank may not resign its duties nor may it be removed from office without a successor having been appointed as aforesaid.

5. Redemption, Conversion and Purchase

(a) Final Redemption

Unless previously redeemed or converted or purchased and cancelled in accordance with this paragraph, the Three Year Notes will be redeemed at their principal amount on the Interest Payment Date falling on or closest to the third anniversary of their Issue Date.

(b) Conversion

The holder of each Three Year Note may not less than 75 nor more than 120 days prior to any Interest Payment Date falling in September, commencing with the Interest Payment Date falling in September, 1987, submit to the Transfer Agent a notice in the form available from the Transfer Agent or any Paying Agent irrevocably requiring the conversion of such Three Year Note into a floating rate Note forming part of the series of U.S.$125,000,000 Floating Rate Notes Due 1999 of the Bank (the "Fifteen Year Notes"). The Bank may instruct the Transfer Agent to accept a notice submitted less than 75 but not less than 60 days prior to such Interest Payment Date but such instruction shall be at the absolute discretion of the Bank. Each such notice shall be accompanied by the relative Three Year Note or Notes, together with all unmatured Coupons appertaining thereto other than the Coupon(s) falling due on such Interest Payment Date, which may be presented for payment on or after such Interest Payment Date in the manner described in paragraph 6 below. Subject to the right of the Bank to redeem the Three Year Note on the relevant Interest Payment Date contained in sub-paragraph (*c*) of this paragraph, the Bank shall cause the Transfer Agent to issue to the holder of each Three Year Note in respect of which such a notice is duly given, on the relevant Interest Payment Date, a Fifteen Year Note at an issue price equal to the principal amount thereof, such price to be discharged by application of the principal sum repayable in respect of such Three Year Note. Pending issue of such Fifteen Year Note, such Three Year Note, together with any other Three Year Notes submitted under this sub-paragraph (*b*) by the same and/or other Noteholders for conversion on the same Interest Payment Date, shall be credited by the Transfer Agent to a blocked account of all such Noteholders and no such Three Year Note may be withdrawn therefrom without the consent of the Bank. Each Fifteen Year Note to be issued shall be in bearer form, shall be of the same principal amount as the Three Year Note in respect of which is is issued, shall be deemed to have been issued on the relevant Interest Payment Date, shall mature on the Interest Payment Date falling in September, 1999 and shall on issue have attached thereto Coupons for payments of interest in respect of such Fifteen Year Note falling due on Interest Payment Dates following the relevant Interest Payment Date up to and including the maturity date. Each Fifteen Year Note to be issued shall be made available for collection at the specified office of the Transfer Agent or shall, if the relative notice so requires, be dispatched by the Transfer Agent, uninsured and at the risk of the Noteholder concerned, to an address outside the United States of America, its territories or possessions. Three Year Notes so submitted shall be repaid, and Fifteen Year Notes to be issued as mentioned above shall be issued, without service charges and without any payment by the Noteholder of any stamp, issue, documentary or other similar taxes, duties or governmental charges.

(c) Redemption at the Option of the Bank

Having given not less than 30 days' nor more than 45 days' notice to the Noteholders, the Bank may redeem all or, from time to time, some (being all of the Three Year Notes maturing on the same date or being U.S.$5,000,000 in principal amount or an integral multiple thereof of such Three Year Notes or of all the Three Year Notes) of the Three Year Notes on any Interest Payment Date falling in or after September, 1987 at their principal amount.

Where partial redemptions are to be effected under this sub-paragraph (*c*), the Three Year Notes to be redeemed will be selected by the Fiscal Agent by drawing individually by lot in London, not less than 30 days before the date fixed for redemption and notice of the serial numbers of the Three Year Notes so drawn and of the date fixed for redemption will be given to the Noteholders in accordance with paragraph 12 below not less than 30 days before the date fixed for redemption.

(d) Redemption for Taxation Reasons

Having given not less than 30 days' nor more than 45 days' notice to the Noteholders, the Bank may on any Interest Payment Date redeem all, but not some only, of the Three Year Notes then outstanding at their principal amount if the Bank has been or would, on the occasion of the next payment due in respect of the Three Year Notes, be required as a result of any change in the tax laws or treaties of the Republic of Korea or in the administration or interpretation thereof to pay additional amounts or make any reimbursement in accordance with the provisions of paragraph 7 below. The provisions of this sub-paragraph (*d*) shall apply separately to each maturity of Three Year Notes.

(e) Optional Purchase

The Bank or any of its subsidiaries may at any time purchase beneficially or procure others to purchase beneficially for its account Three Year Notes in the open market or otherwise at any price, except that on a purchase by private treaty the price (exclusive of expenses and accrued interest) shall not exceed 140 per cent. of the mean of the nominal quotations of that maturity of the Three Year Notes (based on The Stock Exchange Daily Official List) on The Stock Exchange in London (or such other stock exchange as may be the principal stock exchange on which the Three Year Notes are listed) at the close of business on the last business day preceding the date of purchase.

(f) Cancellation

All Three Year Notes redeemed or converted into Fifteen Year Notes or purchased pursuant to this paragraph will be forthwith cancelled (together with all unmatured Coupons appertaining thereto) and may not be reissued or resold.

6. Payments

(a) Payments of principal in respect of Three Year Notes will be made against surrender of Three Year Notes at the specified office of the Fiscal Agent or any Paying Agent by dollar cheque drawn on, or by transfer to a dollar account maintained by the payee with, a bank in New York City. Payments of interest in respect of Three Year Notes will be made against surrender of the appropriate Coupons at any specified office of the Fiscal Agent or any Paying Agent in the manner provided in the preceding sentence, provided that no payments of interest in respect of Three Year Notes will be made at any specified office of the Fiscal Agent or any Paying Agent in the United States of America or any of its territories or possessions. Payments of principal of and interest in respect of the Three Year Notes are subject in all cases to any fiscal or other laws and regulations applicable thereto, but without prejudice to the provisions of paragraph 7 below.

(b) The initial Fiscal Agent and Paying Agents and their initial specified offices are listed at the foot hereof. The Bank reserves the right at any time to vary or terminate the appointment of the Fiscal Agent, provided that there will at all times be a Fiscal Agent, and may terminate the appointment of any Paying Agent and appoint additional or other Paying Agents. The Bank will in all events maintain a Paying Agent in New York City and, so long as the Three Year Notes are listed on The Stock Exchange in London, a Paying Agent in London. Notice of any change in or addition to the Fiscal Agent, the Paying Agents or their specified offices will be published in accordance with paragraph 12 below.

(c) In the case of the redemption of any Three Year Note prior to maturity or the conversion of any Three Year Note into a Fifteen Year Note, the Three Year Note should be presented for payment or, as the case may be, lodged for conversion together with all unmatured Coupons (save, in the case of a Three Year Note lodged for conversion, for the Coupon maturing on the Interest Payment Date on which such conversion is to take place), failing which payment of principal will only be made against the Noteholder giving such indemnity in respect of the missing unmatured Coupons as the Bank may require. Upon the date upon which any Three Year Note becomes due and payable or upon any Three Year Note being purchased and cancelled pursuant to paragraph 5(*f*) above, the unmatured Coupons (if any) appertaining thereto shall become void and no payment shall be due in respect thereof.

(d) If the due date for redemption of any Three Year Note is not an Interest Payment Date, the interest accrued from the preceding Interest Payment Date (or from the Issue Date, as the case may be) shall be payable only against surrender of the relative Three Year Note.

7. Taxation

All payments of principal and interest in respect of the Three Year Notes by the Bank will be made without deduction or withholding for or on account of any present or future taxes or duties of whatever nature levied by or on behalf of the Republic of Korea or any authority thereof or therein, unless deduction or withholding of such taxes or duties is compelled by law. In that event the Bank will pay such additional amounts by way of principal or interest as will result in the payment to the Noteholders or Couponholders of the amounts which would otherwise have been receivable in respect of principal and interest, except that no such additional amount shall be payable in respect of any Three Year Note or Coupon presented for payment:–

(a) by or on behalf of a holder who is subject to such taxes or duties in respect of such Three Year Note or Coupon by reason of his being connected with the Republic of Korea otherwise than merely by holding such Three Year Note or Coupon or receiving principal or interest thereof; or

(b) more than 30 days after the relevant date except to the extent that the holder thereof would have been entitled to such additional payment on presenting the same for payment on the last day of such 30-day period. For this purpose the "relevant date" in relation to any Three Year Note or Coupon means:–

  (i) the due date for payment thereof; or

  (ii) (if the full amount of the moneys payable on such due date has not been received in New York City by the Fiscal Agent on or prior to such due date) the date on which notice to that effect is duly given to the Noteholders and the Couponholders in accordance with paragraph 12 below.

References to principal and/or interest in respect of the Three Year Notes shall be deemed also to refer to any additional amounts which may be payable under this paragraph.

8. Events of Default

If any of the following events ("Events of Default") shall occur:–

(a) default being made for a period of seven days in the payment of any principal moneys in respect of any of the Fifteen Year Notes or Three Year Notes when and as the same ought to be paid in accordance with the terms thereof; or

(b) default being made for a period of fifteen days in the payment of any interest in respect of any of the Fifteen Year Notes or Three Year Notes when and as the same ought to be paid in accordance with the terms thereof; or

(c) the Bank failing duly to perform or observe any covenant, condition or provision contained in the Fifteen Year Notes or Three Year Notes (other than any obligation for the payment of any principal or interest in respect of the Fifteen Year Notes or Three Year Notes) and such failure not being remedied within 30 days following the date on which written notice of such failure, requiring the Bank to remedy the same, shall first have been given to the Bank by any Noteholder; or

(d) any indebtedness of the Bank in the aggregate principal amount of U.S.$1,000,000 or more either (i) becoming due and payable prior to the due date for payment thereof by reason of default by the Bank or (ii) not being repaid at maturity as extended by the period of grace, if any, applicable thereto, or any guarantee or indemnity given by the Bank in respect of Indebtedness of any other person not being honoured when due and called. For the purposes of this paragraph "Indebtedness" means any obligation for the payment or repayment of money borrowed or raised by whatever means (including acceptances, deposits and leasing) or for the deferred purchase price of assets or services; or

(e) the Republic of Korea or any competent authority thereof declaring a moratorium on the payment of any borrowed moneys (including obligations arising under guarantees) by it or by any governmental agency or authority thereof or the Republic of Korea or any competent authority or governmental agency thereof becoming liable to repay prematurely any sums in respect of such borrowed moneys (including obligations arising under guarantees) as a result of a default under, or breach of the terms applicable to, such borrowed moneys or obligations, or the Republic of Korea ceasing to be a member in good standing of the International Monetary Fund or the International Bank for Reconstruction and Development or the international monetary reserves of the Republic of Korea becoming subject to any lien, charge, mortgage, encumbrance or other security interest or any segregation or other preferential arrangement (whether or not constituting a security interest) for the benefit of any creditor or class of creditors; or

(f) the Republic of Korea and the Bank of Korea ceasing to own and control (directly or indirectly) the Bank or for any reason failing to provide the financial support to the Bank stipulated as at the date of issue of the Global Note by Article 23 of the Korea Exchange Bank Act of 1966, as amended; or

(g) the Bank being adjudicated or found bankrupt or insolvent or any order being made by a competent court or administrative agency or any resolution being passed by the Bank to apply for judicial composition proceedings with its creditors or for the appointment of a receiver or trustee or other similar official in insolvency proceedings in relation to the Bank or a substantial part of its assets or the Bank being wound up or dissolved or the Bank ceasing to carry on the whole or substantially the whole of its business,

then the holder of any Three Year Note may by giving written notice to the Bank at the specified office of the Fiscal Agent and without presentment, demand, protest or other notice of any kind, all of which the Bank hereby expressly waives, declare such Three Year Note to be immediately due and payable, where upon such Three Year Note shall become immediately due and payable. Any such notice shall specify the serial number(s) of the Three Year Note(s) concerned and shall be effective only upon receipt thereof.

If any Three Year Note shall become due and payable interest shall accrue thereon until the date upon which, the principal amount of the relevant Three Year Note having been duly paid to the Fiscal Agent, notice thereof is duly given to the holder of such Three Year Note. The Rate of Interest payable shall be calculated at six-monthly intervals (the first of which shall commence on the expiry of the Interest Period during which such Three Year Note becomes due and payable) mutatis mutandis in accordance with the provisions of paragraph 4 above, except that the Rate of Interest and Coupon Amount need not be published.

The Bank shall fully indemnify each Noteholder from and against any reasonable costs, expenses, liabilities and losses which such Noteholder may suffer or incur as a direct result of the occurrence of any Event of Default and/or as a result of such Noteholder's Three Year Note thereby being declared immediately due and payable (including, but without limitation, any expenses incurred in connection with legal proceedings to enforce repayment of such Three Year Note).

9. Prescription

Each Three Year Note and Coupon will become void unless presented for payment within five years from the relevant date, as defined in paragraph 7 above, for payment thereof.

10. Meetings of Noteholders and holders of Fifteen Year Notes

Meetings of Noteholders and holders of Fifteen Year Notes may be convened, which will have the power, inter alia, to sanction by an Extraordinary Resolution, proposed by the Bank, any compromise of, or arrangement in respect of, the rights of the Noteholders and the holders of Fifteen Year Notes, any proposal for exchange of the Fifteen Year Notes and Three Year Notes into other obligations or securities of the Bank or its successors, and any modifications of the terms and conditions of the Notes, provided, however, that the consent of each affected Noteholder and holder of Fifteen Year Notes shall be required for (i) any reduction or cancellation of any amount payable in respect of the Fifteen Year Notes or Three Year Notes, (ii) any reduction in the rate of interest payable in respect of the Fifteen Year Notes or Three Year Notes, (iii) a postponement of the due date for any payment of principal or interest in respect of the Fifteen Year Notes or Three Year Notes, (iv) any variation of the currency in which payments in respect of the Fifteen Year Notes or Three Year Notes are to be made, or (v) any amendment to the majorities required for passing resolutions at meetings of Noteholders and holders of Fifteen Year Notes or modifying the requirements as to unanimous consent by each affected Noteholder and holder of Fifteen Year Notes. The provisions for the convening and holding of meetings of Noteholders and holders of Fifteen Year Notes will be set out in a schedule to the Fiscal Agency Agreement. On all matters raised at any meeting the Three Year Notes and the Fifteen Year Notes shall be treated as one class.

As used herein "Extraordinary Resolution" means a resolution passed, at a meeting of the Noteholders and the holders of Fifteen Year Notes duly convened and held in accordance with the said provisions, by not less than threequarters of the votes cast thereon. At any meeting every Noteholder and holder of Fifteen Year Notes who is entitled to attend such meeting and who (being an individual) is present in person or (being a corporation) is present by its duly authorised representative or by one of its officers as its proxy shall have one vote on a show of hands. On a poll every Noteholder and holder of Fifteen Year Notes who is entitled to attend such meeting and who is present in person or by proxy shall have one vote in respect of each U.S.$10,000 in outstanding principal amount of the Three Year Notes or, as the case may be, Fifteen Year Notes held by him.

11. Replacement of Three Year Notes and Coupons

If a Three Year Note or Coupon is mutilated, defaced, lost, stolen or destroyed it may, at the discretion of the Bank, be replaced at the specified office of the Fiscal Agent in London or the Paying Agent in London on payment of such costs as may be incurred in connection therewith and on such terms as to evidence and indemnity as the Bank may require. Mutilated or defaced Three Year Notes or Coupons must be surrendered before replacements will be issued.

12. Notices

All notices to the Noteholders will be valid if published in one leading London daily newspaper or, if this is not at any time practicable, in at least one leading daily newspaper of general circulation in Europe. It is expected that publications of notices will normally be made in the Financial Times in London.

13. Exchange Rate Indemnity

If a judgment or order is given by a court or tribunal of competent jurisdiction for the payment of any amounts owing in respect of the Three Year Notes or the Coupons to the holders thereof and such judgment or order is expressed in a currency other than dollars, the Bank shall indemnify and hold each Noteholder and Couponholder harmless against any deficiency arising or resulting therefrom (including, without limitation, by reason of any variation in rates of exchange as between the currency in which such judgment or order is given and dollars).

14. No Waiver; Remedies Cumulative

No failure to exercise, and no delay in exercising, on the part of the holder of any Three Year Note or Coupon, any right with respect thereto shall operate as a waiver thereof, nor shall any single or partial exercise thereof preclude any other or future exercise thereof or the exercise of any other right. Rights pursuant to the terms of the Three Year Notes shall be in addition to all other rights provided by law. No notice or demand given in any case shall constitute a waiver of rights to take other action in the same, similar or other instances without such notice or demand.

15. Fiscal Agent, Transfer Agent, Paying Agents and Agent Bank

(a) In acting under the Fiscal Agency Agreement and the Agent Bank Agreement, the Fiscal Agent, the Paying Agents, the Transfer Agent and the Agent Bank respectively are acting solely as agents of the Bank and do not assume any obligation or relationship of agency or trust for or with the holders of the Three Year Notes or Coupons, except that (without affecting the obligations of the Bank to the holders of the Three Year Notes to repay the Three Year Notes in accordance with their terms) any funds received by the Fiscal Agent for the payment of the principal of, or interest in respect of, the Three Year Notes shall be held by it in trust for the Noteholders until the expiry of the period of prescription specified in paragraph 9 above.

(b) The Bank and the Fiscal Agent or (as the case may be) the Agent Bank may, without the consent of any Paying Agent or any Noteholder or Couponholder, agree to any modification of the provisions of the Fiscal Agency Agreement or (as the case may be) the Agent Bank Agreement which, in the reasonable opinion of the Bank and the Fiscal Agent or (as the case may be) the Agent Bank, is not materially prejudicial to the interests of any Noteholder or Couponholder or to any modification thereof which is of a formal, minor or technical nature or is made to correct a manifest error. Any such modification shall be binding on the Noteholders and the Couponholders and (in the case of the Fiscal Agency Agreement) the Paying Agents and notice of any such modification shall (unless the Fiscal Agent or (as the case may be) the Agent Bank agrees otherwise) be given to the Noteholders in accordance with paragraph 12 above as soon as practicable thereafter.

16. Definitions

For the purposes of the terms and conditions of the Three Year Notes and of this summary thereof:–

(a) "outstanding" means, in relation to the Fifteen Year Notes and/or the Three Year Notes (as the case may be), all the Fifteen Year Notes and/or the Three Year Notes (as the case may be) other than, in each case, (i) those which have been redeemed in accordance with their terms and conditions, (ii) those in respect of which the date for redemption in accordance with their terms and conditions has occurred and the principal in respect whereof and all interest payable under the said terms and conditions in respect thereof have been duly paid to the Fiscal Agent in the manner provided in the Fiscal Agency Agreement and remain available for payment against surrender of the relevant Fifteen Year Notes and/or the Three Year Notes and/or Coupons, as the case may be, (iii) those which have been purchased in accordance with paragraph 5(*e*) above and cancelled, (iv) those which have become void under paragraph 9 above, (v) those Fifteen Year Notes which have been converted into Three Year Notes and in respect of which Three Year Notes have been issued pursuant to their terms and conditions, (vi) those Three Year Notes which have been converted into Fifteen Year Notes and in respect of which Fifteen Year Notes have been issued pursuant to their terms and conditions and (vii) those mutilated or defaced Fifteen Year Notes or Three Year Notes, as the case may be, in respect of which replacement notes have been issued pursuant to their Terms and Conditions; and

(b) "redeem" shall include "repay" and vice versa and "redeem", "redemption" and "repay", "repayable" and "repayment" shall be construed accordingly.

17. **Governing Law**

The Three Year Notes, the Coupons and the Fiscal Agency Agreement shall be governed by and construed in accordance with the laws of England. The Bank will submit to the non-exclusive jurisdiction of the courts of the Republic of Korea, the courts of England and the courts of the State of New York and the United States Federal Courts in the State of New York in relation to the Fiscal Agency Agreement, the Three Year Notes and the Coupons, waive any rights of sovereign immunity and agree to appoint an agent for service of process, as provided in the Three Year Notes and the Fiscal Agency Agreement.

USE OF PROCEEDS

The net proceeds from the issue of the Fifteen Year Notes, amounting to approximately U.S.$122,600,000, will be used in the general business of the Bank.

SUBSCRIPTION AND SALE

Morgan Guaranty Ltd, BOT International (H.K.) Limited, BA Asia Limited, Banque Bruxelles Lambert S.A., BT Asia Limited, Commerzbank (South East Asia) Ltd., Credit Lyonnais Hongkong (Finance) Limited, Dai-Ichi Kangyo Finance (Hong Kong) Limited, Daiwa Europe Limited, First Interstate Limited, Kleinwort, Benson (Hong Kong) Limited, Kyowa Bank Nederland N.V., Lloyds Bank International Limited, LTCB Asia Limited, Manufacturers Hanover Asia, Limited, Mitsubishi Finance International Limited, Mitsubishi Trust and Banking Corporation (Europe) S.A., Mitsui Finance Asia Limited, National Australia Finance (Asia) Limited, Nippon Credit International (Hong Kong) Limited, Orion Royal Pacific Limited, Saitama International (Hong Kong) Limited, Sanwa International Finance Limited, Saudi International Bank Al-Bank Al-Saudi Al-Alami Limited, Singapore Nomura Merchant Banking Limited, Standard Chartered Asia Limited, The Sumitomo Trust Finance (H.K.) Limited and Wardley Limited (together the "Managers") have, pursuant to a subscription agreement dated 3rd September, 1984 with the Bank (the "Subscription Agreement"), jointly and severally agreed, subject to certain conditions, to subscribe the Fifteen Year Notes at a price equal to the issue price of 100 per cent. of the aggregate principal amount of the Fifteen Year Notes. Commissions and concessions in an aggregate amount equal to 1⅞ per cent. of the principal amount of the Fifteen Year Notes (comprising a management and underwriting commission of ⅝ per cent. and a selling concession of 1¼ per cent.) will be paid or allowed by the Bank. The Bank will pay all costs incurred in connection with the issue of the Fifteen Year Notes and reimburse the Managers for certain of their expenses. The Managers are entitled to be released and discharged from their obligations under the Subscription Agreement in certain circumstances prior to the payment to the Bank.

The Notes have not been and will not be registered under the Securities Act of 1933 of the United States of America. Accordingly, the Fifteen Year Notes may not as part of the distribution of the Fifteen Year Notes be offered or sold directly or indirectly in the United States (which term, as used herein, means the United States of America, its possessions and territories) or to or for the account of any U.S. person (which term, as used herein, means any person who is a national or resident of the United States, including the estate of any such person, and any corporation or other entity organised under the laws of the United States or any political subdivision thereof) except, as set out below, to Managers or branches of United States banks located outside the United States ("U.S. Bank Branches").

Each Manager has represented and agreed that it has not offered or sold, and has agreed that it will not offer, sell or deliver at any time, directly or indirectly, in the United States or to or for the account of any U.S. Person any Fifteen Year Notes acquired in connection with the distribution contemplated hereby, except for offers for sales to United States Managers. In addition, each Manager has agreed that, prior to 90 days after the date of issue of the Global Note, it will not, directly or indirectly, offer, sell or deliver in the United States or to or for the account of any U.S. Person any Fifteen Year Notes no matter how acquired. Notwithstanding the foregoing, with the prior written approval of Morgan Guaranty Ltd. Fifteen Year Notes may be offered to U.S. Bank Branches provided that each such U.S. Bank Branch which purchases any Fifteen Year Notes represents and agrees in a certificate addressed to Morgan Guaranty Ltd and the Bank and delivered to Morgan Guaranty Ltd prior to such purchase, that, inter alia, it is purchasing such Fifteen Year Notes for its own account for investment and without a view to any distribution or other disposition thereof and that, in the event of any disposition of any such Fifteen Year Notes (such disposition not being foreseen or contemplated at the time such certificate is delivered), it will not offer, sell or deliver any such Fifteen Year Notes directly or indirectly except in compliance with the United States Securities Act of 1933. Each Manager has further agreed that it will send to any dealer who purchases from it any of the Fifteen Year Notes acquired by it in connection with the distribution of the Fifteen Year Notes a notice stating in substance that the Fifteen Year Notes have not been registered under the United States Securities Act of 1933 and that, by purchasing such Fifteen Year Notes, such dealer represents and agrees (i) that it has not offered or sold, and will not offer, sell or deliver at any time, any of such Fifteen Year Notes, directly or indirectly, in the United States or to or for the account of any U.S. Person, and that prior to 90 days after the date of issue of the Global Note it will not offer, sell or deliver, directly or indirectly, in the United States or to or for the account of any U.S. Person any Fifteen Year Notes no matter how acquired and (ii) that it will deliver to any other dealer to whom it sells any of such Fifteen Year Notes a notice containing substantially the same statement as is contained in this sentence.

The Notes may not be offered or sold in Great Britain or Hong Kong, by means of this or any other document, other than to persons whose ordinary business it is to buy or sell shares or debentures, whether as principal or agent, nor may this or any other offering material relating to the Notes be distributed in or from Great Britain or in Hong Kong (except by persons permitted to do so under the securities laws of Great Britain or Hong Kong, as the case may be) otherwise than to persons whose business involves the acquisition and/or disposal, or the holding, of securities (whether as principal or as agent).

Reference should be made to the Subscription Agreement for a complete description of the restrictions on offers and sales of the Notes.

In connection with the offering of the Fifteen Year Notes, the Managers may over-allot or effect transactions with a view to stabilising or maintaining the market price of the Fifteen Year Notes at levels above those which might otherwise prevail in the open market. Such transactions may be effected on The Stock Exchange in London, in any over-the-counter market or otherwise and, if commenced, may be discontinued at any time.

GENERAL INFORMATION

1. The listings of the Fifteen Year Notes and the Three Year Notes on The Stock Exchange in London will be expressed in dollars as a percentage of the principal amount of the Notes (excluding accrued interest); transactions will normally be effected for settlement in dollars and for delivery on the fifth business day after the date of the transaction. It is expected that listings of the Notes on The Stock Exchange in London will be granted on 3rd September, 1984, subject only to the issue of the Notes. Prior to the official listing of the Fifteen Year Notes, however, dealings in the Fifteen Year Notes will be permitted by the Council of The Stock Exchange in London in accordance with its rules.
2. All consents of Korean authorities necessary for the issue of the Notes have been obtained.
3. San Kyong & Co. have given and have not withdrawn their written consent to the inclusion herein or therein of their report in the form and contest in which it appears.
4. Save as disclosed herein, there has been no adverse change in the financial position of the Bank since 31st December, 1983.
5. The Bank is not involved in any litigation or arbitration proceedings of material importance in the context of the issue of the Notes nor, so far as the Bank is aware, are any such litigation or arbitration proceedings pending or threatened.
6. Copies of the following documents may be inspected during the usual business hours on any business day (Saturdays excepted) at the offices of Slaughter and May at 35 Basinghall Street, London EC2V 5DB and at 15th Floor, Connaught Centre, Hong Kong during the period of fourteen days from the date hereof:–
   (i) translations into English of the Korea Exchange Bank Act of 1966, the Presidential Decree enacting the Korea Exchange Bank Act and the By-laws of the Bank;
   (ii) the Subscription Agreement referred to in "Subscription and Sale" above;
   (iii) drafts (subject to amendment) of the Fiscal Agency Agreement (including the text of the Fifteen Year Notes and the Three Year Notes and the coupons appertaining to each such notes) and the Agent Bank Agreement referred to in "Terms and Conditions of the Fifteen Year Notes" and "Terms and Conditions of the Three Year Notes" above; and
   (iv) the report and consent of San Kyong & Company.
7. The Notes have been accepted for clearance through Euro-clear (reference No. 10338) and CEDEL S.A. (reference No. 291935).
8. Certain information and particulars relating to the Bank are available in the exchange telegraph card system operated by Extel Statistical Services Limited.

FINANCIAL STATEMENTS

The following Consolidated Balance Sheet and Consolidated Statement of Earnings for the year ended 31st December, 1983 have been extracted from the audited consolidated Financial Statements of Korea Exchange Bank.

CONSOLIDATED BALANCE SHEET

31st December, 1983
(Expressed in Millions of Won and Thousands of Dollars)

ASSETS	Won	Dollars
Cash and due from banks	W 1,075,483	$ 1,351,959
Foreign exchange purchased	551,041	692,698
Loans	4,489,806	5,644,005
Marketable securities	2,479,751	3,117,223
Customers' liability on guarantees and acceptances	5,503,977	6,918,890
Premises and equipment	242,831	305,256
Investments in securities	227,943	286,541
Other assets	400,099	502,952
	W 14,970,931	$ 18,819,524

LIABILITIES AND EQUITY CAPITAL	Won	Dollars
Liabilities:		
Deposits	W 3,432,807	$ 4,315,282
Foreign exchange sold	35,574	44,719
Borrowing and debentures	5,017,486	6,307,336
Guarantees and acceptances	5,503,977	6,918,890
Guaranty money and foreign exchange transactions	51,109	64,248
Other liabilities	355,849	447,328
Total Liabilities	14,396,802	18,097,803
Commitments and contingencies		
Equity Capital:		
Paid-in capital	355,000	446,260
Reserves	206,039	259,006
Unappropriated Retained earnings	13,090	16,455
Total Equity Capital	574,129	721,721
	W 14,970,931	$ 18,819,524

CONSOLIDATED STATEMENT OF EARNINGS

Year ended 31st December, 1983
(Expressed in Millions of Won and Thousands of Dollars)

	Won	Dollars
Income:		
Interest on loans	W 431,193	$ 542,040
Interest on due from banks	74,099	93,148
Interest on securities	177,260	222,828
Other interest income	115,700	145,443
Total Interest Income	798,252	1,003,459
Fees and commissions	40,786	51,271
Gains on foreign exchange transactions	28,785	36,185
Investment income	1,182	1,486
Other Income	5,015	6,304
Total Income	874,020	1,098,705
Expenses:		
Interest on deposits	260,170	327,052
Interest on borrowings and debentures	427,056	536,840
Other interest expense	4,870	6,122
Total Interest Expense	692,096	870,014
Commission charges	9,663	12,147
Provisions for possible loan losses	22,895	28,780
General and administrative expenses	95,424	119,955
Other expenses	38,176	47,990
Total Expenses	858,254	1,078,886
Earnings before income taxes	15,766	19,819
Income taxes	6,258	7,867
Net earnings	W 9,508	$ 11,952

29th February, 1984

The Board of Directors
KOREA EXCHANGE BANK

We have examined the consolidated balance sheet of Korea Exchange Bank and Subsidiaries at 31st December, 1983, and the related consolidated statements of earnings, equity capital and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards in the Republic of Korea.

In our opinion, the financial statements referred to above present fairly the consolidated financial position of Korea Exchange Bank and Subsidiaries at 31st December, 1983, and the results of their operations and changes in their financial position for the year then ended, in accordance with generally accepted accounting principles in the Republic of Korea and the accounting policies described in the full consolidated financial statements.

The United States dollar amounts shown in the accompanying financial statements have been translated solely for the convenience of the reader. We have reviewed this translation and, in our opinion, the financial statements expressed in Won have been translated into United States dollars at the rate of Won 795.50 per dollar, the mid-rate of exchange at 31st December, 1983 quoted by the Bank of Korea.

San Kyong & Co.

CAPITALISATION OF THE BANK

The following table sets out the capitalisation of the Bank as at 31st December, 1983 on the basis of its consolidated audited accounts as at that date, and the capitalisation of the Bank as at 30th June, 1984 on the basis of (i) its capital and reserves as at 31st December, 1983, and (ii) its long-term debt as at 30th June, 1984 (unaudited, unconsolidated and adjusted to reflect the issue of the Notes):–

	31st December, 1983	30th June, 1984	30th June, 1984
	(in millions of Won)[1]		(in thousands of dollars)[1]
Long-Term Debt[2]			
Domestic Loans	140,462	140,480	174,857
International Loans	2,051,689	2,350,680	2,925,915
Bonds and Notes[3]	61,254	57,845	72,000
Total Long-Term Debt[4]	2,253,405	2,549,005	3,172,772
Add: The Notes being issued	—	80,340	100,000
Total Long-Term Debt, as adjusted	2,253,405	2,629,345	3,272,772
Capital and Reserves			
Capital Stock	355,000	355,000	441,872
Earned Surplus Reserves	209,621	209,621	260,917
Net Profit for year ended 31st December, 1983	9,508	9,508	11,835
Total Capital and Reserves	574,129	574,129	714,624
Total Capitalisation	2,827,534	3,123,134	3,887,396
Total Capitalisation, as adjusted	2,827,534	3,203,474	3,987,396

1. In the statement as at 31st December, 1983 borrowings in currencies other than Won have been translated into Won at rates of exchange equal to the mid-rate of exchange as quoted by Bank of Korea at 31st December, 1983, which in the case of dollars is W795.50=$1.00. In the statements as at 30th June, 1984, borrowings in currencies other than Won have been translated into Won at the mid-rate quoted by Bank of Korea at 30th June, 1984, which in the case of dollars is W803.40=$1.00.
2. For the purpose of this table all short-term debt (including the current portion of long-term debt) has been excluded.
3. Domestic bonds totalling W90,193 million at 31st December, 1983, which were due for repayment in 1984 (Won 76,858 million) and 1985 (Won 13,335 million), have not been included. The table does not include W59,116 million of Domestic bonds issued in 1984 and having various maturity dates in 1985 (W50,489 million) and 1986 (W8,627 million).
4. In addition to the long-term debt shown, the Bank has given guarantees the amount of which outstanding at 31st December, 1983 was W3,879 billion.

There have been no material changes in the capitalisation of the Bank since 30th June, 1984.

REGISTERED OFFICE OF THE BANK

Korea Exchange Bank,
181, 2-ka Ulchiro,
Chung-ku, 100 Seoul,
Republic of Korea.

FISCAL AGENT AND PRINCIPAL PAYING AGENT

Morgan Guaranty Trust Company of New York,
Corporate Trust Office,
30 West Broadway,
New York, N.Y. 10015
(for repayment of principal only)

PAYING AGENTS

Morgan Guaranty Trust Company of New York,
Avenue des Arts 35,
1040 Brussels.

Morgan Guaranty Trust Company of New York,
Mainzer Landstrasse 46,
PO Box 174283,
D–6000, Frankfurt am Main.

Kredietbank S.A. Luxembourgeoise,
43 Boulevard Royal,
Luxembourg.

Swiss Bank Corporation,
Aeschenvorstadt 1,
Basle.

Morgan Guaranty Trust Company of New York,
Morgan House,
1 Angel Court,
London EC2R 7AE.

AGENT BANK

Morgan Guaranty Trust Company of New York,
Morgan House,
1 Angel Court,
London EC2R 7AE.

LEGAL ADVISERS

To the Managers

As to English Law

Slaughter and May,
15th Floor, Connaught Centre,
Hong Kong.

As to Korean Law

Kim Chang & Lee,
Seoul Tokyu Hotel Building, 8th Floor,
120, 6-Ka Namdaemoon-ro,
Chung-ku, 100 Seoul,
Republic of Korea.

To the Bank

Kim & Chang,
Seoul Building, 114-31,
Uni-Dong, Chongru-ku,
Seoul, Republic of Korea.

BROKERS TO THE ISSUE

Vickers Da Costa (UK) Ltd.,
Regis House,
King William Street,
London EC4R 9AR,
England.

AUDITORS TO THE BANK

San Kyong & Co.
Sankyong Building,
3-2 Nonhyon-dong,
Gangnam-ku,
Seoul,
Republic of Korea.

Dated 3rd September, 1984

APPENDIX 2

Types of Documents and the Parties Involved in an FRN Issue

1. Selling Group Agreement

   Parties : Members of the Selling Group, including

   Lead Manager

   Co-managers

   Other Invitees

2. Subscription Agreement

   Parties : Issuer

   Managers, including

   Lead Manager

   Co-managers

3. Agreement Among Managers

   Parties : Lead Manager

   Co-managers

4. Paying Agent Agreement

   Parties : Issuer

   Principal Paying Agent (or Fiscal Agent)

   Paying Agents

   Trustee (if any)

5. Letter Agreement

   Parties : Issuer

   Principal Paying Agent

6. Reference Agency Agreement

Parties : Issuer

Reference Agent

7. Purchase Agency Agreement

Parties : Issuer

Purchase Agent

8. Trust Deed/Fiscal Agency Agreement

Parties : Issuer

Trustee of the Noteholders/Fiscal Agent

9. Auditor's Comfort Letter

Party : The Issuer's Auditor

Appendix 3

INFORMATION MEMORANDUM

Mass Transit Railway Corporation

(A corporation established by the Mass Transit Railway Corporation Ordinance of Hong Kong)

HK$500,000,000

FLOATING RATE BEARER PARTICIPATION CERTIFICATES 1992

(Repayable at the election of Holders in 1989, 1990 and 1991)

issued by Morgan Guaranty Trust Company of New York
evidencing entitlement to payment of
principal and interest on an
advance of HK$500,000,000 made to

Mass Transit Railway Corporation

MORGAN GUARANTY LTD

MANUFACTURERS HANOVER ASIA, LIMITED

BA ASIA LIMITED
BOT INTERNATIONAL (H.K.) LIMITED
CHASE MANHATTAN ASIA LIMITED
EAST ASIA WARBURG LTD.
FUJI INTERNATIONAL FINANCE (HK) LIMITED
HANG SENG FINANCE LTD.
LLOYDS BANK INTERNATIONAL LIMITED
ORION ROYAL PACIFIC LIMITED
SANWA INTERNATIONAL FINANCE LIMITED
WARDLEY LIMITED

BANK OF CHINA HONG KONG
BT ASIA LIMITED
CITICORP CAPITAL MARKETS GROUP
FIRST CHICAGO HONG KONG LIMITED
GRINDLAYS ASIA LIMITED
IBJ ASIA LIMITED
LTCB ASIA LIMITED
PARIBAS ASIA LIMITED
STANDARD CHARTERED ASIA LIMITED

3 SEPTEMBER 1984

The Floating Rate Bearer Participation Certificates 1992 ("BPCs") will be issued in the denomination of HK$500,000 each in the aggregate principal amount of HK$500,000,000 pursuant to an agreement (the "Intermediary Agreement") between Mass Transit Railway Corporation ("MTRC") and Morgan Guaranty Trust Company of New York (the "Intermediary"). The BPCs are being sold as part of arrangements under which an Advance of HK$500,000,000 will be made to MTRC under the Intermediary Agreement.

MTRC has agreed to repay the Advance and to pay interest thereon by making payment, respectively, to the holders of the BPCs and the holders of the Coupons appertaining thereto. Interest will be payable quarterly and will, except as mentioned herein, be at an annual Rate of Interest of ¼ per cent above the Hong Kong Interbank Offered Rate for three month Hong Kong dollar deposits for each Interest Period quoted by Reference Banks (subject to a minimum Rate of Interest of 5¼ per cent per annum) in such manner as is more fully described in the Intermediary Agreement.

The Advance may, at the option of MTRC, be repaid, in whole or in part, without penalty or premium on the Interest Payment Date falling in September 1986 or on any Interest Payment Date thereafter. The BPCs may, at the option of Holders, be paid at their principal amount on each Interest Payment Date falling in September 1989, 1990 and 1991. See "The Intermediary Agreement and the BPCs — Repayment".

Payments in respect of the BPCs will be made by Paying Agents in Hong Kong, Brussels and Luxembourg. Payments of interest in respect of the Coupons will be made subject to the deduction of Hong Kong interest tax (or of any other Hong Kong tax for the time being payable by way of withholding or deduction) unless an exemption therefrom applies. See "The Intermediary Agreement and the BPCs — Taxation".

Morgan Guaranty Trust Company of New York as tender agent (the "Tender Agent") on behalf of the Managers is inviting certain institutions to tender competitive bids for the BPCs. The minimum tender price is 99.25%. Tendered bids will be accepted no later than 7 September 1984. See "Arrangements for Offer for Sale".

Application has been made to list the BPCs on the Luxembourg Stock Exchange.

A temporary global BPC without interest coupons in the amount of HK$500,000,000 will be delivered to Morgan Guaranty Trust Company of New York as operator of the Euro-clear System on or about 20 September 1984 and will be exchangeable for definitive BPCs not later than 19 November 1984.

No person has been authorised to give any information or to make any representation save as contained in this Information Memorandum in connection with the offering of the BPCs and, if given or made, such information or representation must not be relied upon as having been authorised by MTRC, the Tender Agent, the Intermediary or by any of the Managers (as defined herein). Neither the delivery of this Information Memorandum nor any sale made hereunder or pursuant hereto shall, under any circumstances, create any implication that there has been no change in the affairs of MTRC since the date hereof.

This Information Memorandum does not constitute an offer of, or an invitation to purchase, any of the BPCs. This Information Memorandum may not be used for or in connection with an offer or solicitation by anyone in any jurisdiction in which such offer or solicitation is not authorised or to any person to whom it is unlawful to make such offer or solicitation. (Your attention is drawn to "Selling Restrictions" on page 30.)

MTRC has taken all reasonable care to ensure that the facts stated herein in relation to itself and the BPCs are true and accurate in all material respects and that in the context of this issue there are no other material facts the omission of which would make misleading any statement herein whether of fact or opinion. MTRC accepts responsibility accordingly. The Intermediary does not accept any responsibility for the contents of this Information Memorandum.

In this Information Memorandum, unless otherwise specified or the context otherwise requires, references to "HK Dollars", "HK$" and "$" are to Hong Kong dollars. References to "billions" are to thousands of millions.

In connection with the offering of the BPCs, the Managers may over-allot or effect transactions in the BPCs in the open market or otherwise with a view to stabilising or maintaining the market price of the BPCs at levels other than those which might otherwise prevail in the open market. Such transactions, if commenced, may be discontinued at any time.

References to "Managers" mean the twenty-one financial institutions, starting with Morgan Guaranty Ltd, listed on the cover page of the Information Memorandum.

TABLE OF CONTENTS

THE INTERMEDIARY AGREEMENT AND THE BPCs

On or prior to the Closing Date, MTRC and the Intermediary will enter into the Intermediary Agreement to provide for the issue of the BPCs by the Intermediary and to provide for the advance to MTRC of the sum of HK$500,000,000. On 3 September 1984, the Managers entered into a Purchase Agreement with MTRC under which the Managers agreed to purchase the BPCs from the Intermediary and to offer the same for sale by tender (see "Arrangements for Offer for Sale"). Copies of the Intermediary Agreement, in which the form of BPC is set out, will be available for inspection at the specified office of the Intermediary and at the specified offices of the Paying Agents as set out herein. Holders of the BPCs (the "BPC-holders") and of the coupons (the "Coupons") appertaining thereto (the "Couponholders") will be deemed to have notice of, and to have agreed to all the provisions contained in, the Intermediary Agreement. A summary of the detailed provisions of the Intermediary Agreement and the BPCs is set out below. Expressions defined in the Intermediary Agreement shall have the same meanings when used herein.

The Advance

The Advance will, subject to the prior satisfaction of certain conditions precedent, be made to MTRC on the Closing Date (as defined in the Purchase Agreement and which is expected to be 20 September 1984). MTRC will undertake to repay, and to pay interest on, the Advance in the manner set out in the Intermediary Agreement as summarised below.

BPCs — Form and Denomination; Coupons

Each BPC will be in bearer form and will provide that title thereto shall pass by delivery. Each BPC will evidence the entitlement of the holder thereof to receive out of the repayment of the Advance on the Interest Payment Date (as defined below) falling in September 1992, or on such earlier date as the Advance (or any relevant portion thereof) may become repayable pursuant to the Intermediary Agreement, the principal amount of HK$500,000 and until such repayment is made to receive a proportionate share of the interest payable on the Advance pursuant to the Intermediary Agreement. On issue, Coupons will be attached to each BPC and interest payments will be made against surrender of the appropriate Coupons as described in "Payments" below. The BPCs will rank equally amongst themselves without any preference or priority.

Interest

(a) Interest Periods

Interest shall be calculated and payable on the Advance by reference to successive Interest Periods. Each Interest Period shall be the period from and including an Interest Payment Date to but excluding the next succeeding Interest Payment Date, except that the first Interest Period shall be the period from and including the Closing Date to but excluding the first Interest Payment Date.

The expression "Interest Payment Date" is defined in the Intermediary Agreement to mean the date which falls three calendar months after the Closing Date and thereafter each date which falls three calendar months after the preceding Interest Payment Date, provided that if any Interest Payment Date would by application of the foregoing fall on a day which is not a Business Day it shall be postponed to the next Business Day, unless as a result of such postponement, it would fall in the next calendar month, in which event such Interest Payment Date shall be the immediately preceding Business Day, and each subsequent Interest Payment Date shall be the last Business Day of the third calendar month after the calendar month in which the preceding Interest Payment Date shall have fallen.

(b) Reference Agent and Reference Banks

The rate of interest applicable during any Interest Period (the "Rate of Interest") shall be determined by a reference agent (the "Reference Agent") acting pursuant to an agreement entered into with MTRC (the "Reference Agent Agreement") and in accordance with the provisions set out in (c) below. MTRC has appointed the Chartered Bank to act as the Reference Agent. In the event of the Chartered Bank being unable or unwilling to continue to act as Reference Agent, MTRC has undertaken to appoint another bank (being a leading bank with an office in Hong Kong) to act as Reference Agent in its place.

MTRC has undertaken to procure that there shall at all times be four Reference Banks for the purposes of the Intermediary Agreement. The initial Reference Banks shall be the principal Hong Kong offices of The Chartered Bank, Lloyds Bank International Limited, Morgan Guaranty Trust Company of New York and The Sanwa Bank, Limited. In the event of the principal Hong Kong office of any such bank being unable or unwilling to continue to act as Reference Bank, MTRC shall appoint another bank (being a leading bank with an office in Hong Kong) to act as such in its place.

(c) Rate of Interest

The Rate of Interest from time to time applicable shall be determined by the Reference Agent on the basis of the following provisions:

(i) on the first day of each Interest Period ("Interest Determination Date"), the Reference Agent will request each of the Reference Banks to provide the Reference Agent with its offered quotation to leading banks for HK Dollar deposits in Hong Kong for the Interest Period concerned as at 11.00 am. (Hong Kong time) on the Interest Determination Date in question. The Rate of Interest for such Interest Period shall, subject to (iv) below, be ¼ per cent per annum above the arithmetic mean (rounded upwards if necessary to the nearest ¹⁄₁₆ per cent) of such offered quotations, as determined by the Reference Agent;

(ii) if on any Interest Determination Date one or two of the Reference Banks fails to provide the Reference Agent with such offered quotations, the Rate of Interest for the relevant Interest Period shall, subject to (iv) below, be determined in accordance with (i) above on the basis of the offered quotations of the Reference Banks providing such quotations;

(iii) if on any Interest Determination Date only one or none of the Reference Banks provides the Reference Agent with such offered quotations, the Rate of Interest for the relevant Interest Period shall, subject to (iv) below, be the higher of (a) ¼ per cent per annum above the rate per annum quoted by The Hongkong and Shanghai Banking Corporation as its prime or best lending rate for HK Dollars at 11.00 a.m. (Hong Kong time) on the Interest Determination Date and (b) the Rate of Interest in effect on the last day of the immediately preceding Interest Period;

(iv) in no event shall the Rate of Interest be less than 5¼ per cent per annum.

(d) Payment of Interest

On each Interest Payment Date, MTRC shall pay interest accrued on the Advance during the Interest Period ending on that Interest Payment Date at the rate applicable for that Interest Period. The amount of interest to be paid on the Advance in respect of each Interest Period shall be calculated by applying the applicable Rate of Interest to the amount of the Advance, multiplying such sum by the actual number of days in the Interest Period concerned divided by 365 and rounding the resultant figure to the nearest cent (half a cent being rounded upwards). Payment of interest will be made only in the manner described under "Payments" below.

(e) Publication of Rate of Interest and Coupon Amount

The Reference Agent will, in respect of each Interest Period, cause the Rate of Interest, the amount of interest payable on the presentation and surrender of each Coupon (the "Coupon Amount") and the relevant Interest Payment Date to be published in accordance with "Notices" below, as soon as possible but not later than five Business Days after the date of commencement of the relevant Interest Period. The Coupon Amount and the Interest Payment Date so published may subsequently be amended without notice in the event of an extension or shortening of the relevant Interest Period.

Repayment

(a) At Maturity

Unless previously repaid, the Advance shall be repaid by MTRC in full on the Interest Payment Date falling in September 1992. Except as specifically provided in paragraphs (b), (c) and (d) below, MTRC may not prepay the Advance until that date.

(b) Prepayment at the option of MTRC

MTRC may prepay the Advance or any part of it which is a minimum of HK$25,000,000 and an integral multiple of HK$5,000,000 on the Interest Payment Date falling in September 1986 or on any Interest Payment Date thereafter, without premium or penalty, on giving to the Intermediary and the BPC-holders not less than 45 and not more than 60 days' notice specifying the amount and the date of the prepayment. Should MTRC elect to prepay part of the Advance, BPCs to be prepaid will be selected individually by lot in Hong Kong not less than 40 days prior to the due date for prepayment and MTRC shall give not less than 30 days' notice to the BPC-holders of the date fixed for prepayment, of the serial numbers of BPCs to be so prepaid and of the principal amount of the Advance which will remain outstanding after such prepayment.

(c) Purchase by MTRC

MTRC may at any time and at any price purchase BPCs. Any BPCs so purchased shall be surrendered by MTRC to any Paying Agent for cancellation and the Advance will be deemed to be prepaid by MTRC by the principal amount of BPCs purchased and cancelled as aforesaid.

(d) Prepayment at the election of BPC-holders

MTRC shall prepay on each Interest Payment Date falling in September 1989, 1990 and 1991 a part of the Advance equal to the principal amount of the BPCs which BPC-holders have elected to have prepaid. To exercise such election, the BPC-holder must deposit the BPCs in question, together with all Coupons appertaining thereto maturing after such Interest Payment Date, with any Paying Agent not less than 60 nor more than 90 days prior to the relevant Interest Payment Date. Any BPC so deposited shall not be withdrawn without MTRC's prior written consent.

(e) Payment

The Advance or any portion thereof may be repaid or prepaid only in the manner described under "Payments" below.

Payments

(a) Payments to be made to BPC-holders or Couponholders

MTRC and the Intermediary have acknowledged and agreed that payments of the principal of, and interest on, the Advance pursuant to the Intermediary Agreement will be made to, and are for the benefit of, the holders of the BPCs and the Coupons, respectively.

(b) Method of Payment

Payments of the principal of the Advance will be made against surrender of the BPCs and payments of interest on the Advance will be made on and after each Interest Payment Date against surrender of the Coupons relevant to that Interest Payment Date at the specified offices of the Paying Agents, which are at the date hereof: (i) the specified office of The Chartered Bank in Hong Kong, (ii) the offices of Morgan Guaranty Trust Company of New York in Brussels, and (iii) the offices of Banque Internationale à Luxembourg in Luxembourg as set out herein.

Payments will be made, subject to applicable laws and regulations, at any of the specified offices of the Paying Agents by HK Dollar cheque or bank draft drawn on, or by transfer to a HK Dollar account maintained by the payee with, a bank in Hong Kong.

MTRC reserves the right to terminate the appointment of any Paying Agent and at any time to vary the appointment of any Paying Agent and to appoint additional or other Paying Agents, provided that it will at all times maintain a Paying Agent in Hong Kong and in a European city which, for so long as the BPCs are listed on the Luxembourg Stock Exchange, shall be Luxembourg. Notice of any such termination or appointment and of any change in the specified offices of any of the Paying Agents will be given to the BPC-holders in accordance with "Notices" below.

BPCs should be presented for payment together with all unmatured Coupons appertaining thereto, failing which payment of principal will only be made against the BPC-holders giving such indemnity in respect of the missing unmatured coupons as MTRC may require. Unless the due date for payment in respect of any BPC or Coupon is a day in which banks are open for business in Hong Kong and in the place where such BPC or, as the case may be, the relevant Coupon is presented for payment, the holder thereof shall not be entitled to payment until the next such day in both such places or to any interest or other payment in respect of such delay. Upon the date on which any BPC becomes due and payable or on which any BPC purchased by MTRC as provided in (c) under "Repayment" above is delivered for cancellation to a Paying Agent, unmatured Coupons relating thereto (whether or not attached) shall become void and no payment shall be made in respect thereof.

Taxation

(a) Payments of Principal

All payments of the principal of the Advance against due presentation of the BPCs will be made by MTRC without deduction or withholding for or on account of any present or future taxes or duties of whatever nature imposed or levied by or on behalf of Hong Kong, or any authority in Hong Kong, unless the deduction or withholding of such taxes or duties is required by law. In that event MTRC will pay such additional amounts as may be necessary in order that the net amounts after such deduction or withholding shall equal the amount of principal which would have been receivable in respect of the BPCs in the absence of such deduction or withholding.

References herein to the principal of the Advance shall be deemed also to refer to any additional amounts which may be payable under the obligations referred to in this paragraph.

(b) Payments of Interest

All payments of interest on the Advance against due presentation of the Coupons will be made subject to the deduction of Hong Kong interest tax (or of any other Hong Kong tax for the time being payable by way of withholding or deduction on payments of interest) at the standard or other applicable rate for the time being in force unless the person by whom or on whose behalf any Coupon is presented for payment and who is entitled to such payment, by signing and completing when required by MTRC or the relevant Paying Agent to whom such Coupon is presented, a Form of Confirmation and Indemnity in a form to be provided for the purpose by such Paying Agent (and by producing such additional evidence and/or verification as MTRC or such Paying Agent may require):

(i) confirms to MTRC and such Paying Agent that, when paid to such person, such amount will be, or that such person by or on whose behalf such Coupon is presented will be, exempt from Hong Kong interest tax (or such other Hong Kong tax) pursuant to the Inland Revenue Ordinance (Cap.112 of the Laws of Hong Kong) or any statutory modification or re-enactment thereof (or other applicable Hong Kong legislation) and

(ii) undertakes to indemnify MTRC and such Paying Agent against any liability to which MTRC or such Paying Agent may be or become subject in respect of Hong Kong interest tax (or such other Hong Kong tax) on such amount or the payment thereof

in which event the relevant amount shall (subject to any other legal obligation under Hong Kong law to withhold or deduct notwithstanding such exemption) be paid by MTRC and such Paying Agent to the person who presents such Coupon for payment and who is entitled to the face amount thereof without deduction of Hong Kong interest tax (or such other Hong Kong tax).

Status and Negative Pledge

So long as the Advance or any part thereof remains outstanding:

(a) MTRC will ensure that at all times the Advance will rank at least pari passu and rateably without preference or priority (except for any statutory preference or priority applicable in the winding up of MTRC) with all other unsecured indebtedness, loans, guarantees or other obligations, contingent or otherwise, of MTRC;

(b) MTRC shall not create or have outstanding any mortgage, charge, pledge or other security interest (other than a lien arising by operation of law) upon the whole or any part of its undertaking or assets, present or future, in order to secure any existing or future Securities issued by, or guarantees in respect thereof granted by, it unless in any such case at the same time either the Advance is equally and rateably secured so as to rank pari passu with such Securities or guarantees or such other security is provided to secure the Advance which (together with any security provided previously, if any) in the opinion of the Intermediary provides substantially an equivalent level of security. For the purpose of this paragraph, the term "Securities" means any indebtedness in the form of or represented by bonds, notes, debentures or other securities, or by bills of exchange drawn or accepted for the purpose of raising money, which are, or are at the time of issue or acceptance intended to be, quoted, listed or ordinarily traded on any stock exchange or over the counter securities market or traded between financial institutions or institutional investors.

Events of Default

The Intermediary at its discretion may, and if so requested in writing by the holders of not less than one-quarter of the BPCs valid and outstanding or if so directed by an Extraordinary Resolution of the BPC-holders shall, (but in the case of the happening of any of the events referred to in paragraphs (d), (e), (f) or (g) below only if the Intermediary shall have certified to MTRC that such event is, in its opinion, materially prejudicial to the interests of the BPC-holders) declare by giving notice to MTRC that the Advance is immediately repayable if:

(a) there is a default for more than 7 days in the payment of the principal amount of the Advance or any portion thereof as and when the same shall become due and payable; or

(b) there is a default for more than 7 days in the payment of any interest due in respect of the Advance or any portion thereof; or

(c) MTRC shall default in the payment of any principal of or interest on any obligation for Borrowed Money beyond any period of grace provided in respect thereof, or MTRC shall fail to honour when due and called upon any guarantee of any indebtedness for Borrowed Money, in an aggregate principal amount of HK$10,000,000, or the equivalent thereof in other currency or currencies, or a general moratorium shall be declared on the payment of debts of MTRC; or

(d) indebtedness for Borrowed Money of MTRC, in an aggregate principal amount of HK$10,000,000, or the equivalent thereof in other currency or currencies, shall become due and payable prior to its specified maturity by reason of any default or event of default (however described); or

(e) MTRC shall default in the performance or observance of any undertaking given by it in the Intermediary Agreement or in any other document delivered thereunder and (unless the same shall not be capable of remedy) such default shall not have been remedied within thirty (30) days after notice thereof from the Intermediary to MTRC; or

(f) any representation or warranty made by MTRC in the Intermediary Agreement or in any written certificate, notice or statement delivered pursuant to the Intermediary Agreement shall prove to have been incorrect or misleading in any material respect when made or deemed made; or

(g) the Intermediary Agreement shall become unenforceable or at any time it is unlawful for MTRC to perform its obligations thereunder or any judgment or order shall be made or any legislation shall be passed the effect of which would be to render ineffective or invalid the Intermediary Agreement or any part of the Intermediary Agreement; or

(h) MTRC shall dispose of or attempt to dispose of all or a substantial part of its assets or undertaking required for use in connection with the Railway (except pursuant to or as part of such an amalgamation or reconstruction as is mentioned in paragraph (i) below); or

(i) any competent action shall be taken, any enactment shall be passed, any judgment or order of a court of competent jurisdiction shall be made or any effective resolution shall be passed for the winding up or dissolution of MTRC the effect of which would be to dissolve or liquidate MTRC or to transfer to a third party all or a substantial part of its assets or undertaking required for use in connection with the Railway (except where its corporate existence is to be terminated or otherwise affected, or any such transfer made pursuant to or as part of an amalgamation or reconstruction (i) the effect of which is demonstrated by MTRC to the reasonable satisfaction of the Intermediary to be to vest in some other corporate body all of its undertaking, properties and assets, or such of them as are required for use in connection with the Railway and to impose upon such other corporate body all of the obligations and liabilities of MTRC or, as the case may be, such of them as relate to the Railway, including all the obligations and liabilities of MTRC under the Intermediary Agreement, or (ii) which, in any other case, has previously been approved in writing by the Intermediary); or

(j) any encumbrancer shall take possession or a receiver or other similar officer shall be appointed of the whole or any substantial part of the assets or undertaking of MTRC required for use in connection with the Railway or a distress or execution shall be levied or enforced upon or sued out against any substantial part of the assets or undertaking of MTRC required as aforesaid and shall not be stayed or discharged within sixty (60) days of being levied or enforced; or

(k) a decision is taken by the Board of MTRC or by any other authority of or within Hong Kong to close the Railway for a period exceeding one year; or

(l) as a result of any action on the part of MTRC or the Government of Hong Kong or as a result of any new law or regulation of Hong Kong, the Government of Hong Kong either ceases to control the composition of the Board of MTRC or the Government of Hong Kong ceases to hold more than half in nominal value of the equity share capital of MTRC (and so that expressions used in this paragraph (l) shall have the meanings that would be applicable under Section 2, Companies Ordinance (Cap.32 of the Laws of Hong Kong) if both MTRC and the Government of Hong Kong were companies for the purpose of that Section and the Board of MTRC were its board of directors);

Upon any such declaration as aforesaid the Advance shall immediately become repayable with accrued interest as provided for in the Intermediary Agreement provided that if at any time after an Event of Default shall have occurred and before the Intermediary shall have made any such declaration in respect of that Event of Default, the Event of Default shall have been remedied to the satisfaction of, or shall have been waived in writing by, the Intermediary by notice to MTRC, then such Event of Default shall be deemed never to have occurred, and the Intermediary shall not be entitled to make any such declaration in respect of the Event of Default.

Enforcement

In entering into the Intermediary Agreement and in issuing the BPCs the Intermediary is acting as principal and not as the agent of the BPC-holders or any of them, and the Intermediary Agreement does not and the BPCs do not create or constitute any trust, whether express or implied. Accordingly no BPC-holder or Couponholder shall be entitled to institute action against MTRC to enforce their respective rights under the Intermediary Agreement, and the Intermediary shall not assume or be under any liability to any BPC-holder or Couponholder except as expressly set out in the BPCs and the Coupons.

At any time after the Advance shall have become repayable pursuant to "Events of Default" above, the Intermediary may at its discretion and without further notice institute such proceedings as it may think fit against MTRC to enforce payment thereof together with accrued interest to the BPC-holders but shall not be bound to do so unless:

(a) it shall have been so requested in writing by the holders of not less than one-quarter of the BPCs then valid and outstanding or so directed by an Extraordinary Resolution of the BPC-holders; and

(b) it shall have been indemnified to its satisfaction.

Replacement of BPCs and Coupons

Should any BPC or Coupon be mutilated, destroyed, stolen or lost it may be replaced at the specified office for the time being of the Paying Agent in Luxembourg upon payment by the claimant of the expenses incurred in connection therewith and on such terms as to evidence, security and indemnity as MTRC and the Intermediary may require. Mutilated BPCs or Coupons must be surrendered before replacements will be issued.

Prescription

BPCs and Coupons will become void unless presented for payment within a period of 6 years from the Relevant Date (as defined in the Intermediary Agreement) relating thereto.

Notices

All notices regarding the BPCs will be valid if published in one leading English language Hong Kong daily newspaper and, so long as the BPCs are listed on the Luxembourg Stock Exchange, in one leading Luxembourg daily newspaper or, if either is not possible, additionally in one leading English language daily newspaper of general circulation in Europe or (as the case may be) the Far East. Any notice so published shall be deemed to have been given on the date of such publication or, if published more than once, on the date of the first such publication. It is expected that publication of notices will normally be made in the South China Morning Post in Hong Kong and in the Luxemburger Wort in Luxembourg. Any notice from the Intermediary to MTRC or from MTRC to the Intermediary shall be effective only on receipt.

Meetings of BPC-holders, Modification and Waiver

The Intermediary Agreement will contain provisions for convening meetings of BPC-holders to consider any matter affecting their interests, including the modification by Extraordinary Resolution of the terms and conditions of the BPCs and, as described below, the Intermediary Agreement. The quorum at any meeting for considering and if thought fit passing an Extraordinary Resolution will be persons holding or representing a clear majority in principal amount of the BPCs for the time being valid and outstanding, or at any adjourned meeting two or more persons being or representing BPC-holders whatever the principal amount of the BPCs held or represented, except that at any meeting the business of which includes consideration of proposals for the modification of certain terms and conditions of the BPCs or of the Intermediary Agreement, the necessary quorum for passing an Extraordinary Resolution will be persons holding or representing not less than three-quarters, or at any such adjourned meeting not less than one-quarter, in principal amount of the BPCs for the time being valid and outstanding. The majority required for the passing of an Extraordinary Resolution at a meeting duly convened and held shall be not less than three-quarters of the votes cast thereon. An Extraordinary Resolution passed at any meeting of BPC-holders will be binding on all BPC-holders, whether or not they are present at the meeting, and on all Couponholders.

Except as provided in this paragraph the Intermediary shall not, unless so authorised by an Extraordinary Resolution of BPC-holders, agree to any amendment of the Intermediary Agreement. Notwithstanding the foregoing, the Intermediary may agree, without the consent of the BPC-holders or Couponholders, to any modification (subject to certain exceptions) of, or to the waiver or authorisation of any breach or proposed breach of, any of the terms and conditions of the Intermediary Agreement which is not, in the opinion of the Intermediary, materially prejudicial to the interests of the BPC-holders or to any modification which is of a formal, minor or technical nature or which is made to correct a manifest error. Any such modification, waiver or authorisation shall be binding on the BPC-holders and the Couponholders and, unless the Intermediary agrees otherwise, shall be notified to the BPC-holders as soon as practicable thereafter.

Substitution of the Intermediary

If a petition is presented or a resolution is proposed for the winding-up of the Intermediary, MTRC shall thereupon nominate a successor company being a bank or trust corporation incorporated in England, the United States of America or Canada and unconnected with MTRC which shall be substituted as Intermediary under the Intermediary Agreement and for the purposes of the BPCs. The Intermediary Agreement contains further provisions permitting the replacement (in the event of certain changes to the tax laws of Hong Kong or the place of incorporation of the Intermediary or the place from which it is operating), the removal (with the approval of an Extraordinary Resolution of BPC-holders) or resignation of the Intermediary.

Intermediary Relieved from Liability and May Rely on Experts

The Intermediary Agreement contains provisions relieving the Intermediary from liability to MTRC under certain circumstances and the BPCs contain like provisions relieving the Intermediary from liability to BPC-holders. The Intermediary shall be entitled to rely on the opinions of auditors, legal advisers, bankers and other experts chosen by it, and shall incur no liability to MTRC or BPC-holders, if it acts on advice obtained by it from such experts.

Governing Law

The Intermediary Agreement and the BPCs will be governed by and construed in accordance with the laws of England. MTRC will submit to the non-exclusive jurisdiction of the courts of England, Hong Kong and New York for all purposes in relation to the Intermediary Agreement.

USE OF PROCEEDS

The net proceeds from the Advance will be used by MTRC for general corporate purposes. The minimum amount of net proceeds will be approximately HK$495 million, which will be increased depending on the bidding prices achieved in the auction of the BPCs.

CAPITALISATION OF MTRC

The following table sets forth the unaudited capitalisation of MTRC as at 30 June 1984, as adjusted to reflect the borrowing of the Advance. Except as indicated herein, there has been no material change in the capitalisation of MTRC since 30 June 1984.

	30 June 1984	As Adjusted
	(HK$ million)	
Long-Term Debts		
Loans in Hong Kong dollars due beyond one year	10,908	10,908
Loans in Hong Kong dollars current portion (due within one year)	904	904
Loans in other currencies due beyond one year (a)	1,184	1,184
Loans in other currencies current portion (due within one year) (a)	756	756
9-3/8% bonds due 1986	400	400
The Advance	—	500
Long-Term Debts (b)	14,152	14,652
Shareholder's Funds		
Share Capital 51,740 shares issued and fully paid (authorised 55,000 shares of HK$100,000 each)	5,174	5,174
Cumulative loss	(2,233)	(2,233)
Net Shareholder's Funds (c)	2,941	2,941
Total Capitalisation (d)	17,093	17,593

Notes:

(a) Major foreign currency debts were translated at the following approximate exchange rates, which are the weighted average of forward exchange rates under transactions entered into by MTRC and the spot rates prevailing on 30 June 1984:

HK$7.821 = US$1
HK$10.89 = 1 Pound Sterling
HK$2.839 = DM1

(b) All long-term debt is unsecured. HK$6,590 million of the long-term debt is guaranteed by the Hong Kong Government, being primarily export credits.

(c) MTRC has never paid any dividend, in cash or stock.

(d) None of MTRC's subsidiaries has any external long-term borrowing.

SELECTED FINANCIAL INFORMATION

The following table sets forth selected financial information of MTRC for the years ended 31 December:

	(HK$ million)				
	1979 (a)	1980	1981	1982 (c)	1983 (c)
Total Revenue	—	304 (b)	457	820	1,035
Profit (Loss) before Interest and Finance Charges	—	(21)(b)	20	180	253
Net Profit (Loss)	—	(504)(b)	(491)	(269)	(750)
Total Assets	9,048	10,683	12,546	16,224	20,292
Total Liabilities	7,903	10,011	8,837	12,409	17,213
Shareholder's Funds	1,145	672	3,709	3,815	3,079

Notes:

(a) There was no profit and loss statement for the accounting period ended 31 December 1979.

(b) These figures relate to the period from 12 February 1980 to 31 December 1980.

(c) MTRC first produced consolidated accounts in 1983 and, in producing its accounts for that year, restated the 1982 figures to reflect the new accounting policy. Accordingly, the figures in this table for 1982 and 1983 are consolidated figures.

MASS TRANSIT RAILWAY CORPORATION

Background

MTRC is a Hong Kong corporation established in September 1975 by the Mass Transit Railway Corporation Ordinance (the "Ordinance") and has its registered office and headquarters at 33, Wai Yip Street, Kowloon Bay, Hong Kong. MTRC is wholly owned by the Hong Kong Government (the "Government"). The Ordinance provides that the principal objects of MTRC are (1) to construct an underground railway system or mass transit railway in Hong Kong, (2) to operate such system or railway having regard to the reasonable requirements of the public transport system and (3) to engage in such other activities and to perform such functions as the Governor may permit or assign to it. The Ordinance further provides that MTRC may do such things as are expedient for or conducive to these objects. It also requires that MTRC shall conduct its business according to prudent commercial principles and shall ensure as far as possible that, taking one year with another, its revenue is at least sufficient to meet its expenditure.

The Ordinance further provides that MTRC is subject to directions of a general character in the public interest by the Governor in Council but that it is to be fully compensated by the Government if any such direction requires it to act contrary to prudent commercial principles.

MTRC has three wholly-owned subsidiaries. MTR (Estates Management) Limited currently provides management services to residential and commercial properties owned or developed by MTRC. The Governor has permitted MTRC to engage in providing bus feeder services to its stations and to act as consultant or project manager in respect of all types of transport-related activities in Hong Kong and elsewhere. For these purposes, MTRC has formed MTR Buses Limited and MTR Engineering Services Limited respectively.

Unlike most other public transport companies in Hong Kong, MTRC is not subject to statutory fare control by the Government but is empowered by the Ordinance to determine the fares which it charges.

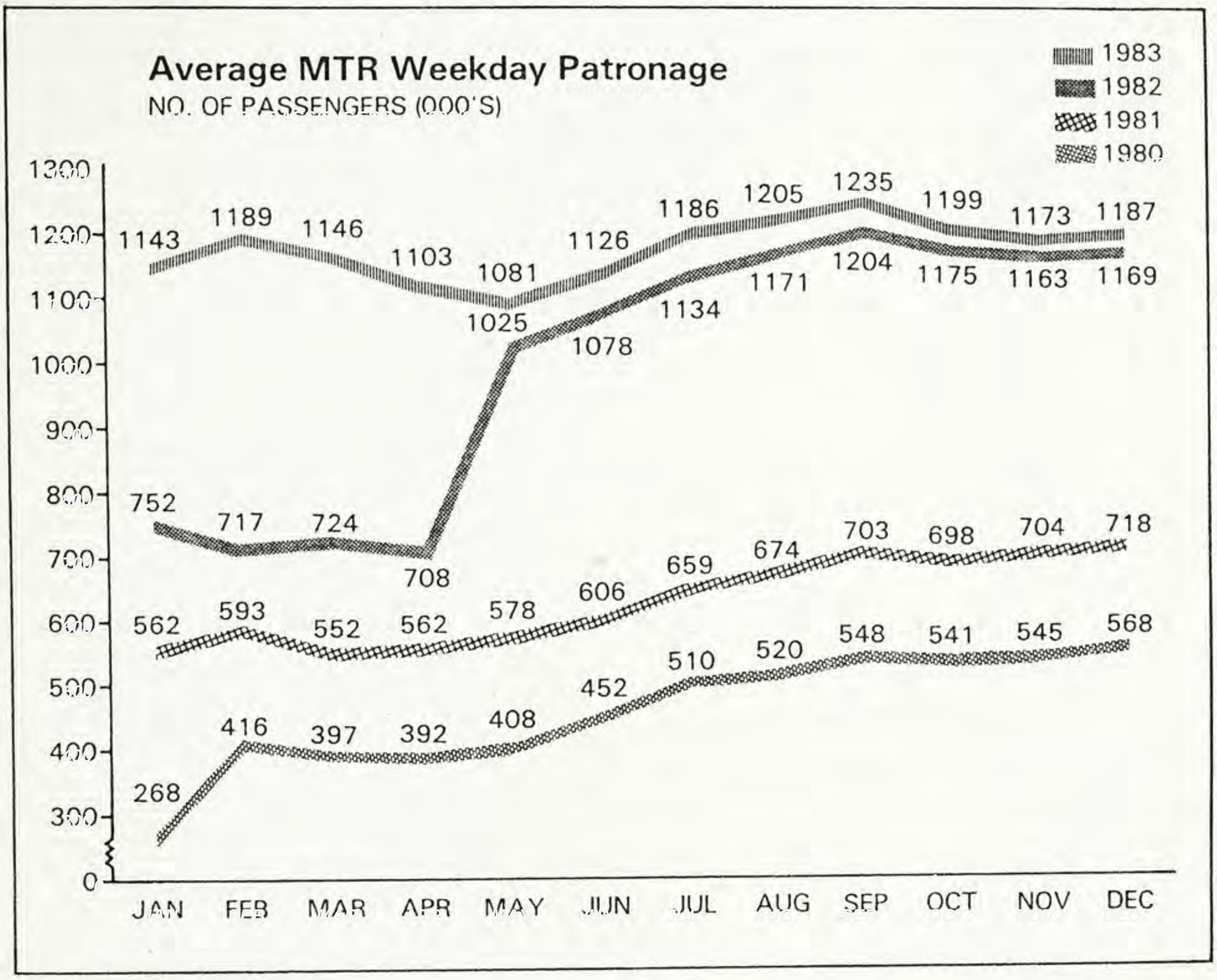
The Railway

MTRC operates a 26.13 kilometres (Km) railway system comprising the Tsuen Wan Line and the Kwun Tong Line. The two lines were completed in phases between October 1979 and May 1982 at a total cost (exclusive of financing costs) of HK$9.5 billion.

The Tsuen Wan Line is a route of some 15.63 Km of which 13.75 Km are underground and 1.88 Km are overhead. It runs from Central on Hong Kong Island to Tsuen Wan in the New Territories and has 13 underground and 3 overhead stations and a depot at Tsuen Wan.

The Kwun Tong Line operates from Waterloo in mid Kowloon to Kwun Tong in east Kowloon. There are interchange facilities between the two lines at Waterloo, Argyle and Prince Edward Stations, and interchange facilities with the Kowloon-Canton Railway at Kowloon Tong Station. The route is of some 10.5 Km of which 7.5 Km are underground and 3 Km are overhead. There are 9 underground and 3 overhead stations, including interchange stations, and a depot at Kowloon Bay.

The first full operational year of the present system was 1983. In that year the total number of passengers carried by MTRC reached 412 million, up from 351 million in 1982. The average MTRC weekday patronage for the years 1980 to 1983 is depicted in the following graph:

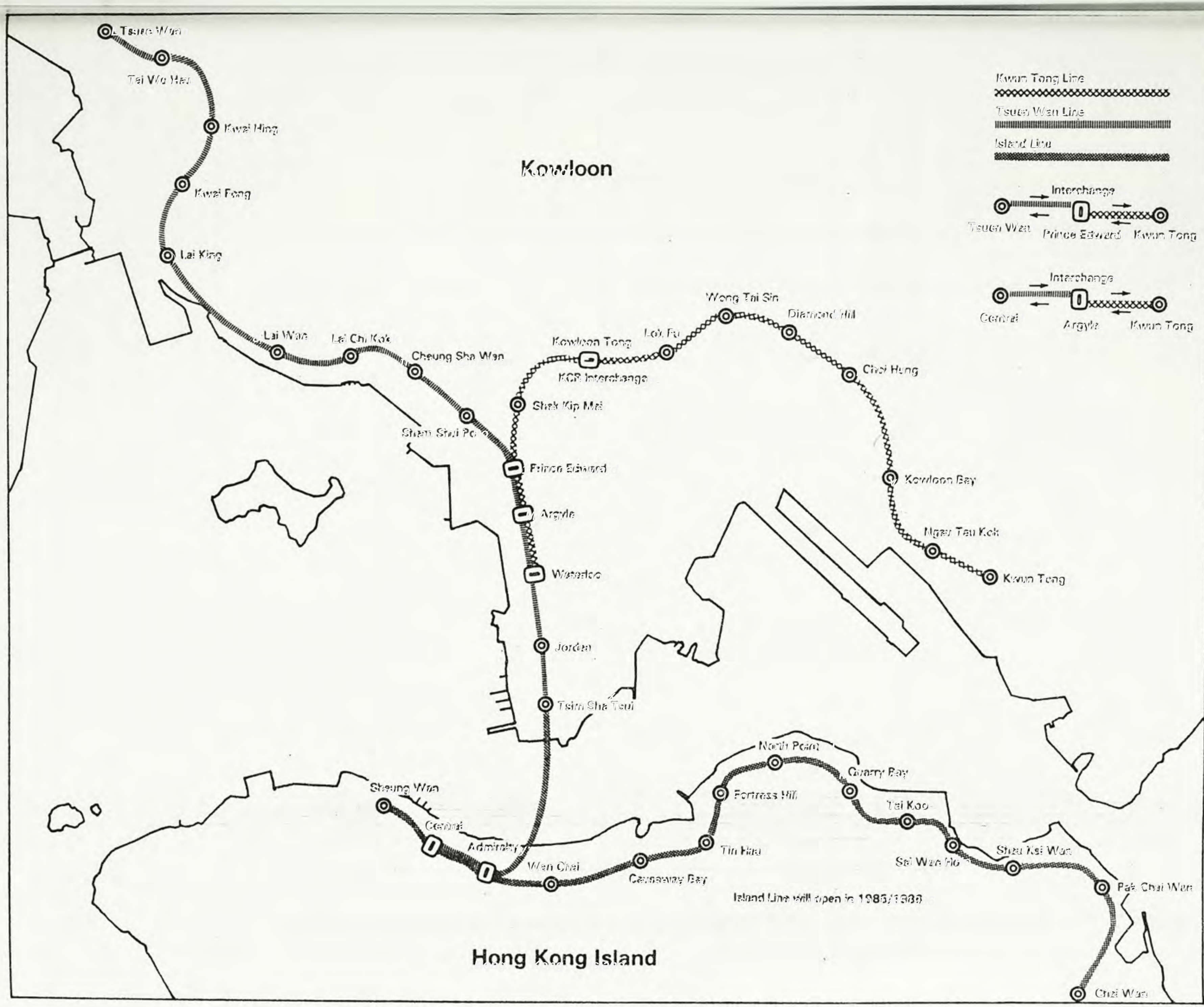


MTRC employs a high degree of computerisation in the operation of the railway. The trains themselves are controlled by automatic systems both with regard to the regulation of acceleration, braking and coasting and to the control of speed on a specific section of track. The issue and collection of tickets are also fully automatic and the tickets themselves are plastic with a magnetic strip upon which a code indicating the time, date and place of issue and the fare paid is imprinted. MTRC issues stored value tickets which are encoded with particular values from which fares for journeys are automatically deducted upon the completion of such journeys. Plans are presently being implemented to introduce a Common Stored Value Ticket in conjunction with Kowloon-Canton Railway Corporation permitting crossticketing.

In December 1980, the Government approved the construction of a 12.5 Km line (the "Island Line") running along the north shore of Hong Kong Island. This project is technically difficult and involves tunnelling through rock and reclaimed land below some of the most densely populated urban areas in the world. MTRC's 1981 estimate for the cost of the project was approximately HK$11 billion (exclusive of financing costs) and this estimate has not changed since then. The first section of the Island Line running between Admiralty and Chai Wan is expected to commence operations in June 1985 and the second section between Admiralty and Sheung Wan is scheduled for completion in September 1986. There will be interchange facilities with the existing system at Admiralty and Central Stations. MTRC estimates that at the end of August 1984 eighty-five per cent of the civil engineering works had been completed. On electrical and mechanical works, the manufacturing, fabrication and installation works were approximately sixty-three per cent complete. MTRC expects the construction to be completed and the Island Line to open on schedule and within budget.

The map on page 12 shows the entire railway system upon completion of construction.

Hong Kong Mass Transit Railway System



— 12 —

Property Development

In 1975 the Government gave approval to MTRC to engage in property development associated with the railway stations and depots. MTRC has since been involved in joint venture developments with property developers.

The principle adopted by MTRC when negotiating with property developers is that the developers generally have to fund the development costs including land premium, construction cost and finance charges and bear all development risks. Profits are shared between MTRC and developers with any minimum share to MTRC usually guaranteed by advance cash payments.

Completed property developments associated with the existing railway consist of 128,800 square metres of commercial office space, 96,200 square metres of shops, and 10,856 residential units. Substantially all residential flats and offices have been sold. Shops have either been sold or are almost fully let.

MTRC has entered into several agreements with development consortia in connection with the construction of the Island Line. These agreements follow the same principle as set out above and in most cases with the added stipulation that the developers have to undertake to fund the construction of railway works related to the sites. The cost of railway works, therefore, represents the minimum cash contribution to MTRC whether or not the property development proceeds. Of the Island Line developments, Fairmont House, consisting of 20,956 square metres of office space in Central, was completed and sold in 1982. Construction work for another major development at Kornhill near Tai Koo Station has recently begun. The project is scheduled for completion in phases from 1985 to 1990. Upon completion, it will provide some 9,400 flats with sizes ranging from 45 to 113 square metres together with extensive commercial and community facilities. In July 1984, MTRC also entered into an agreement with a property development consortium to develop a residential estate above and adjacent to the Pak Chai Wan Station and depot. This estate will provide approximately 7,500 residential flats with sizes varying from 49 to 65 square metres, together with commercial and community facilities. A detailed development plan is still under preparation and construction work is expected to commence in January 1985. MTRC is also discussing proposals with developers for other sites along the Island Line.

MTRC's cumulative property development profit realised in the period from 1980 to the end of 1983 exceeded HK$1.1 billion.

MTRC, currently through MTR (Estates Management) Limited, provides management services to most of the properties developed by MTRC. Its current portfolio includes three office buildings, four shopping centres and 10,256 residential units.

Finance

MTRC's present major financing needs are for the construction of the Island Line, debt servicing and general corporate purposes.

MTRC estimates the construction cost of the Island Line to be about HK$11 billion, excluding financing costs. As of 30 June 1984, MTRC had obtained approximately HK$4.7 billion fixed-rate export credit financing and approximately HK$1 billion cash contribution from the Island Line property developments, almost none of which had been brought into profit and loss by that date. The balance is being financed from bank facilities and other capital market sources.

Of the Island Line construction cost, approximately HK$7 billion has already been spent and has been taken to Construction in Progress in the balance sheet as of 30 June 1984. Therefore, approximately HK$4 billion remains as capital commitments outstanding.

MTRC has raised finance from a variety of sources, including direct loans from individual banks, syndicated loans and commercial paper programmes in Hong Kong and the United States.

At 30 June 1984, MTRC had available committed facilities of approximately HK$21 billion of which HK$14 billion had been drawn down. Repayment of the outstanding loans at 30 June 1984 extends over the period from 1984 to 1995 as shown in the table below:

Long-Term Debt Repayment Schedule (a)
(HK$ million)

1984(b)	1985	1986	1987	1988	1989	1990-1995	Total
759(c)	3,059	2,315	2,056	1,947	1,228	2,788	14,152

(a) The repayment schedule excludes repayment of the Advance
(b) for July to December 1984
(c) HK$1,705 for full year

Since 30 June 1984 approximately HK$1.3 billion in additional committed facilities have been arranged.

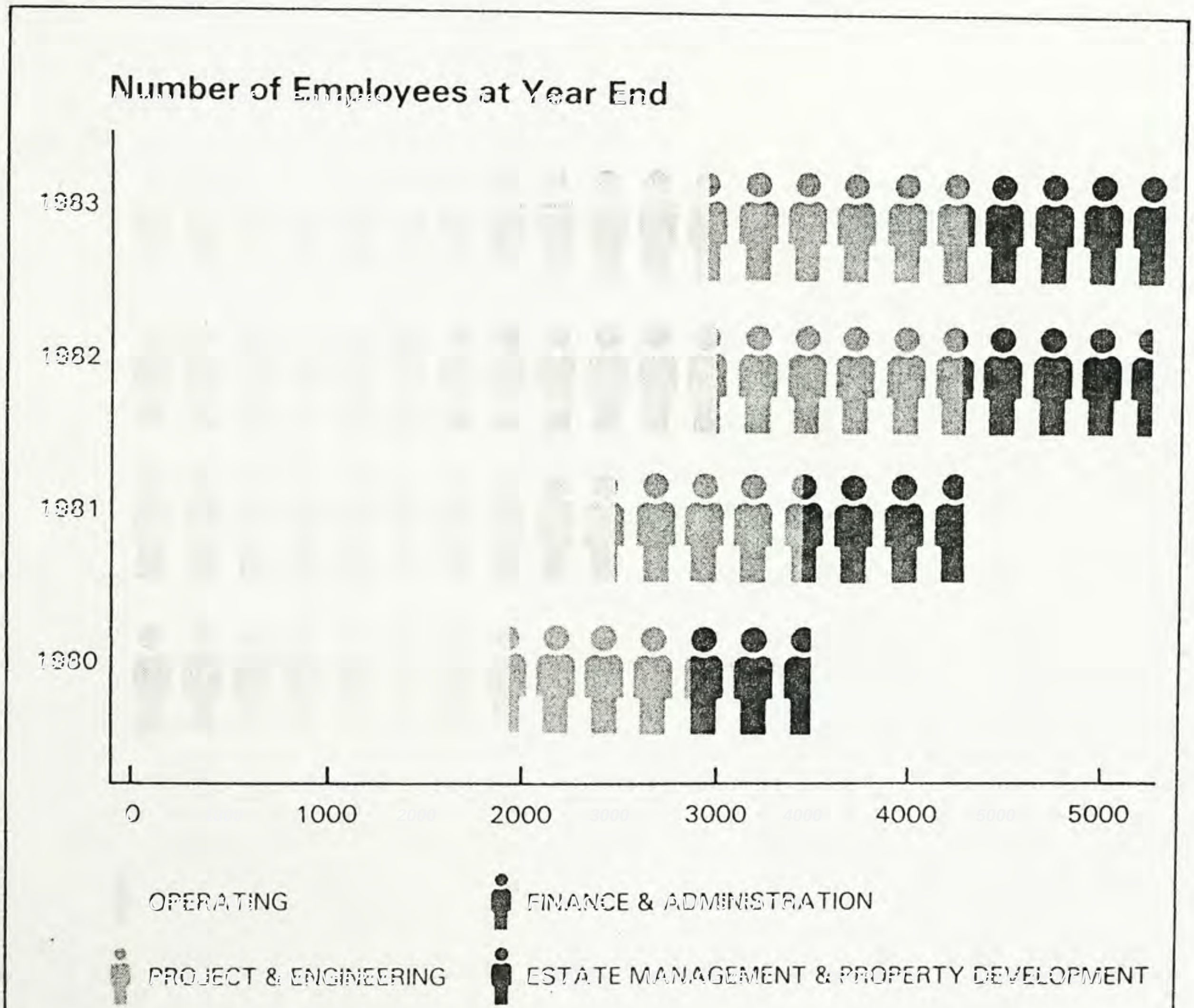
MTRC expects that operating revenue, together with undrawn committed facilities, will be adequate to provide for the remaining capital commitments of the Island Line and also to service all its debts throughout 1984 and 1985. Further drawings of these committed facilities and/or new borrowings will affect the Debt Repayment Schedule set out above.

Employees

MTRC employed approximately 5,100 persons at the end of June 1984. MTRC consults the views of its employees, through elected representatives, when formulating staff policy. Joint Consultative Committees were first established in 1980 and now cover all departments in MTRC. A Staff Consultative Council also exists comprising elected representatives from each Joint Consultative Committee to form a company-wide consultative body. Chaired by MTRC's Managing Director, the Staff Consultative Council meets regularly to discuss matters of common interest and concern.

MTRC has embarked on a number of programmes aimed at increasing work efficiency and productivity. MTRC considers that its labour relations are generally good. Since the establishment of MTRC in 1975, MTRC has had two strikes by a relatively small number of employees. The two strikes, both of which occurred in 1984, lasted a total of five days but on neither occasion were the operations of MTRC materially affected.

The following chart shows the number of employees and their distribution within MTRC at the end of 1983:



Board and Management

The Ordinance provides for the appointment of a Board to be the governing body of MTRC. The Board comprises a Chairman appointed by the Governor of Hong Kong, a Managing Director appointed by MTRC with the Governor's approval and not less than four nor more than eight other members appointed by the Governor. The members of the Executive Directorate are senior full time employees of MTRC. The present members of the Board and Executive Directorate are as follows: –

Members of the Board

C.W. Newton
Chairman
E.A. Black
Managing Director
D.W.A. Blye
The Hon. W.C.L. Brown
The Hon. N.K. Chan
Secretary for Lands and Works,
Hong Kong Government
(ex officio)
The Hon. Oswald Cheung
The Hon. Lydia Dunn
G.M. Macwhinnie
The Hon. A.J. Scott
Secretary for Transport,
Hong Kong Government
(ex officio)
C.H. Tung

Members of Executive Directorate

D.B.G. Barraclough
Operations Director
W.J. Greig
Engineering & Project Director
W.S. Lau
Finance Director
M.G. Parson
Director & Secretary

PUBLIC TRANSPORT IN HONG KONG

MTRC operates its railway system in high-density population areas in Hong Kong. In addition to the railway operated by MTRC, public transport services in Hong Kong include franchised motor bus services, ferry services, the Kowloon-Canton Railway, public light buses and two tramways on Hong Kong Island. All of these except the railway operated by MTRC and the Kowloon-Canton Railway are operated by private sector companies and most of them are either direct or indirect competitors of MTRC for passenger journeys. As the following table shows, MTRC's share of total passenger journeys has increased to 18.9% in 1983.

Public Transport: Passenger Journeys (in thousands) by Type of Service

	1979	1980	1981	1982	1983
Mass Transit Railway	11,742	167,533	222,914	351,082	411,955
Kowloon Motor Bus	934,339	911,657	933,025	940,396	981,823
China Motor Bus	274,324	275,533	287,461	311,909	348,084
Hongkong Tramways	150,935	159,183	160,442	143,371	131,093
Hongkong & Yaumati Ferry	142,415	131,994	126,557	114,765	100,132
Star Ferry	56,538	46,551	41,359	38,113	37,406
Public Light Bus	18,003	37,617	50,780	69,947	103,953
Kowloon Canton Railway	18,353	19,341	17,123	22,215	48,110
Others	14,210	13,690	12,229	12,333	12,769
Total	1,620,859	1,763,099	1,851,890	2,004,131	2,175,325
MTRC's Share	0.7%	9.5%	12.0%	17.5%	18.9%

Source : Hong Kong Monthly Digest of Statistics – April 1984

REPORT OF THE INDEPENDENT PUBLIC CERTIFIED ACCOUNTANTS

Report of the Auditors to
the Members of the Board of
Mass Transit Railway Corporation

We have examined the balance sheets of the Mass Transit Railway Corporation as at 31st December 1982 and 31st December 1983, the profit and loss accounts for the four years ended 31st December 1983 and the statements of changes in financial position for the two years ended 31st December 1983. Our examinations were made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

The Corporation has not applied the provisions of Statement of Standard Accounting Practice 123, in that a lower depreciation charge has been made than would have been required if the provisions of this Standard had been applied to certain leasehold land, tunnels, buildings and underground and overhead structures. Had the provisions of this Standard been applied, further depreciation charges of $103 million, $113 million, $280 million and $320 million for the years ended 31st December 1980, 1981, 1982 and 1983 respectively would have been required. This would have resulted in a corresponding reduction in the book value of fixed assets of $506 million for the year ended 31st December 1982 and $826 million for the year ended 31st December 1983.

Except for the above, in our opinion, these financial statements present fairly the financial position of the Mass Transit Railway Corporation as at 31st December 1982 and 31st December 1983, the losses for the four years ended 31st December 1983 and the changes in financial position for the two years ended 31st December 1983 in accordance with accounting principles generally accepted in Hong Kong applied on a consistent basis.

PEAT, MARWICK, MITCHELL & CO.
Certified Public Accountants

3rd September 1984
Hong Kong

Mass Transit Railway Corporation
Consolidated Profit and Loss Account
for the years ended 31 December
(HK$ Million)

	Note	1980(a)	1981(a)	1982	1983
REVENUE	2	304	457	820	1,035
Operating Costs & Expenses	3	189	276	406	477
OPERATING PROFIT BEFORE DEPRECIATION		115	181	414	558
Depreciation		136	161	234	305
PROFIT BEFORE INTEREST AND FINANCE CHARGES		(21)	20	180	253
Interest and Finance Charges	4	675	552	567	788
LOSS BEFORE EXTRAORDINARY ITEMS		(696)	(532)	(387)	(535)
EXTRAORDINARY ITEMS					
Profit on Sales of Development Properties		572	41	311	181
Provision for Exchange Translation Difference	5	(380)	—	(193)	(396)
LOSS FOR THE YEAR		(504)	(491)	(269)	(750)

The notes on pages 22 to 29 form part of these Accounts.

(a) The Profit and Loss Account for 1980 and 1981 give the unconsolidated results of the Mass Transit Railway Corporation only. The result of the subsidiaries for those years were not material.

Mass Transit Railway Corporation
Consolidated Balance Sheet
As at 31 December 1983
(HK$ Million)

	Note	1982	1983
FIXED ASSETS — at cost less provision for depreciation	6	12,481	12,275
CONSTRUCTION IN PROGRESS	7	3,069	6,810
LONG TERM RECEIVABLES		102	224
		15,652	19,309
CURRENT ASSETS	8	572	983
Less: CURRENT LIABILITIES	9	3,439	5,070
		(2,867)	(4,087)
TOTAL NET ASSETS		12,785	15,222
REPRESENTED BY			
SHARE CAPITAL			
Authorised			
55,000 shares of $100,000 each		5,500	5,500
Issued and fully paid 50,933 (1982 50,788) shares of $100,000 each	10	5,079	5,093
Loss for the year		(269)	(750)
Accumulated loss at 1 January		(995)	(1,264)
Accumulated loss at 31 December		(1,264)	(2,014)
Net Shareholder's Funds		3,815	3,079
9-3/8% BONDS DUE 1986		400	400
LOANS	11	7,680	11,098
DEPOSITS AND ADVANCES RECEIVED	13	850	580
DEFERRED LIABILITIES	14	40	65
		12,785	15,222

C W Newton) Approved by
W C L Brown) Members of the Board
) 2 April 1984

The notes on pages 22 to 29 form part of these Accounts.

Mass Transit Railway Corporation
Balance Sheet
As at 31 December 1983
(HK$ Million)

	Note	1982	1983
FIXED ASSETS — at cost less provision for depreciation	6	12,476	12,269
CONSTRUCTION IN PROGRESS	7	3,069	6,810
LONG TERM RECEIVABLES		102	224
		15,647	19,303
CURRENT ASSETS	8	569	980
Less: CURRENT LIABILITIES	9	3,471	5,126
		(2,902)	(4,146)
TOTAL NET ASSETS		12,745	15,157
REPRESENTED BY			
SHARE CAPITAL			
Authorised			
55,000 shares of $100,000 each		5,500	5,500
Issued and fully paid 50,933 (1982 50,788) shares of $100,000 each	10	5,079	5,093
Loss for the year		(269)	(750)
Accumulated loss at 1 January		(995)	(1,264)
Accumulated loss at 31 December		(1,264)	(2,014)
Net Shareholder's Funds		3,815	3,079
9-3/8% BONDS DUE 1986		400	400
LOANS	11	7,680	11,098
DEPOSITS AND ADVANCES RECEIVED	13	850	580
		12,745	15,157

C W Newton) Approved by
W C L Brown) Members of the Board
) 2 April 1984

The notes on pages 22 to 29 form part of these Accounts.

Mass Transit Railway Corporation
Consolidated Statement of Changes in Financial Position
for the year ended 31 December 1983
(HK$ Million)

	1982	1983
INTERNAL SOURCE OF FUNDS		
Loss for the year	(269)	(750)
Adjustment for items not involving the movement of funds		
Depreciation	234	305
Exchange translation differences	193	396
Provision for loss on development properties	—	15
Prior years' receipts and expenditure in respect of development properties sold during the year	20	(89)
	178	(123)
OTHER SOURCE OF FUNDS		
Shares issued	375	14
Contract/General finance loans drawn down (net)	2,615	3,022
Deposits received	—	100
Funding from developer deducted from development properties' construction cost	242	—
	3,410	3,013
APPLICATION OF FUNDS		
Railway construction cost and acquisition of fixed assets	3,707	4,108
Development properties' construction cost	217	2
Decrease in deposits received (net)	109	—
Increase in long-term receivables	102	122
	4,135	4,232
	(725)	(1,219)
INCREASE/(DECREASE) IN WORKING CAPITAL		
Contract downpayments	(74)	19
Stores and spares	27	—
Vested materials	(18)	50
Debtors and payments in advance	206	342
Creditors and provision for construction costs	(484)	(570)
Contract retentions	(72)	(148)
Movement in net liquid funds:		
Net increase in bank overdrafts and balances, short-term loans and deposits	(310)	(912)
	(725)	(1,219)

Notes on the Accounts

1. ACCOUNTING POLICIES

a) Basis of Preparation

Although not required to do so under the Mass Transit Railway Corporation Ordinance 1975, these accounts have been prepared so as to comply with the disclosure provisions of the Companies Ordinance. Except as detailed in 1(c) below, the accounts have been prepared on an accruals basis and therefore reflect the assets acquired and the liabilities incurred at 31 December 1983.

b) Basis of Consolidation

The consolidated accounts include the accounts of Mass Transit Railway Corporation and its subsidiary companies as at 31 December 1983.

c) Construction in Progress

Expenditure incurred on main contracts represents payments on account and amounts due based upon values actually certified for the period up to and including 31 December 1983 in relation to the agreed payment terms contained within each contract. Work done by contractors after the last date of each certification but before 31 December 1983 has not been provided for in these accounts.

d) Capitalisation of Construction Costs

Costs attributable to projects, including finance costs and other overheads, are initially debited to construction in progress and are capitalised on completion of the relevant projects.

e) Depreciation

All fixed assets other than land, tunnels, underground civil structures and rails are depreciated at the following rates calculated to write off the cost of each asset over its estimated useful life:–

Overhead structures and immersed tube	1%p.a.
Buildings and depot structures	2%p.a.
Station architectural finishes	5%p.a.
Rolling stock, signalling equipment, environmental control system, lifts and escalators, station kiosks and other mechanical equipment	5%p.a.
Telecommunication system, automatic fare collection system, advertising panels, maintenance equipment, office furniture and equipment etc.	10%p.a.
Motor vehicles and cleaning equipment	20%p.a.
Site offices	25%p.a.

No depreciation has been charged on land.

No depreciation has been charged on tunnels and underground civil structures because of their specialised and permanent nature.

The initial cost of rails has not been depreciated, the cost of replacements being written off to profit and loss account as and when incurred.

f) Estates Development

Profits on developments for re-sale are taken into account after completion of the sales agreements for a substantial proportion of the development, issue of occupation permits and receipt of a substantial proportion of sales proceeds. Until that time, expenditure incurred on the development of the properties and land premia is charged to construction in progress, and initial deposits received on account of the sales proceeds are credited to deposits and advances received.

In the case of multi-block developments where sales completions generally take place over a protracted period of time, profits are brought into acount only on substantial completion of the whole development and on the receipt by the Corporation of a substantial proportion of the sales proceeds due to it.

The expenditure incurred on the development of properties for retention is charged to construction in progress until such time as the occupation permits are issued and thereupon is transferred to fixed assets.

g) Interest

The full value of accrued interest on each loan drawing is provided in the accounts whether the interest is actually paid or capitalised in the loan. Until commencement of operations, interest payable is included in construction in progress. Thereafter, the portion attributable to the financing of net operating assets is charged to profit and loss account.

h) Stores and Spares

Stores and spares are valued at standard cost.

i) Foreign Currency Translations

Foreign currency transactions are converted at exchange rates ruling at the transaction dates. Foreign currency balances have been translated into Hong Kong dollars at the exchange rates ruling at the balance sheet date except for balances where foreign exchange contracts have been entered into, in which case the forward rates applicable to the contracts have been used for translation. Differences on foreign currency transactions are dealt with in the profit and loss account with the exception of those relating to loans drawn down in respect of construction in progress, which are capitalised.

2. REVENUE

Revenue comprises fare revenue and other income. Fare revenue amounted to $960 million (1982 $764 million). Other income consisted mainly of advertising and rental income.

3. OPERATING COSTS AND EXPENSES

Operating costs and expenses include auditors' remuneration of $651,600 (1982 $553,355) and amortisation of pre-operating expenditure of $143,418 (1982 $143,418).

4. INTEREST AND FINANCE CHARGES

Interest in respect of	1982 $M	1983 $M
Bank loans, overdrafts and loans wholly repayable within five years	508	736
Other loans	49	47
	557	783
Finance charges	10	5
	567	788

5. EXCHANGE TRANSLATION DIFFERENCES

At 31 December 1983, the total loans outstanding drawn down in foreign currency and expressed in Hong Kong dollars at the rates of exchange ruling at the date of drawdown amounted to $2,292 million. These loans, expressed at approximately the rates of exchange ruling at 31 December 1983 or, in the case of certain liabilities covered by forward exchange contracts, at the forward purchase rates, amounted to $3,161 million. The difference of $869 million was fully provided for by a charge to the profit and loss account of $396 million, the balance of $473 million being provision brought forward from the 1982 accounts not utilised.

6. FIXED ASSETS

Consolidated	Leasehold Land in Hong Kong $M	Tunnels and Underground Structures $M	Overhead Structures, Buildings and Immersed Tube $M	Plant and Other Equipment $M	Total $M
Cost					
At 1 January 1983	395	5,685	1,923	5,023	13,026
Additions	—	1	1	76	78
Disposals	—	—	—	(5)	(5)
Reallocations	—	(129)	(109)	238	—
Transfer from construction in progress	28	—	—	—	28
At 31 December 1983	423	5,557	1,815	5,332	13,127
Aggregate depreciation					
At 1 January 1983	—	—	39	506	545
Written back on disposals	—	—	—	(2)	(2)
Charge for the year	—	—	23	286	309
	—	—	62	790	852
Net book value at 31 December 1983	423	5,557	1,753	4,542	12,275
Net book value at 31 December 1982	395	5,685	1,884	4,517	12,481

The Corporation	Leasehold Land in Hong Kong $M	Tunnels and Underground Structures $M	Overhead Structures, Buildings and Immersed Tube $M	Plant and Other Equipment $M	Total $M
Cost					
At 1 January 1983	395	5,685	1,923	5,017	13,020
Additions	—	1	1	75	77
Disposals	—	—	—	(5)	(5)
Reallocations	—	(129)	(109)	238	—
Transfer from construction in progress	28	—	—	—	28
At 31 December 1983	423	5,557	1,815	5,325	13,120
Aggregate depreciation					
At 1 January 1983	—	—	39	505	544
Written back on disposals	—	—	—	(2)	(2)
Charge for the year	—	—	23	286	309
	—	—	62	789	851
Net book value at 31 December 1983	423	5,557	1,753	4,536	12,269
Net book value at 31 December 1982	395	5,685	1,884	4,512	12,476

The Corporation's interest in certain properties at Admiralty Centre for which no consideration is payable, is reflected in the accounts at a nominal value of $1.

Depreciation for the year includes $305 million in respect of depreciation on railway operating assets charged to the profit and loss account. The balance of $4 million, which has been capitalised, represents depreciation on fixed assets used on the construction of the Island Line.

The cost of land represents land premia paid to the Government comprising the following:

	1982 $M	1983 $M
Medium-term leasehold land (less than 50 years and greater than 10 years)	389	389
Long-term leasehold land (more than 50 years)	6	34
	395	423

7. CONSTRUCTION IN PROGRESS

	Railway $M	Estates Development $M	Total $M	1982 $M
Total Cost Incurred to 31 December 1983				
MAIN CONTRACTS	4,903	70	4,973	2,143
LAND	—	46	46	215
ASSOCIATED CONSTRUCTION COSTS				
Costs including site investigation, road and utility diversion necessary to facilitate construction	20	—	20	18
Land clearance costs and rentals	458	—	458	123
Compensation payments	9	—	9	3
	487	—	487	144
OVERHEADS				
Staff salaries and expenses	362	—	362	156
General expenses (including $4M depreciation)	78	—	78	41
Consultants fees	266	6	272	207
	706	6	712	404
FINANCE COSTS				
Interest (net) and discount on bills payable	523	4	527	118
Commitment, management and legal fees etc. incurred in loan raising and loan management	65	—	65	45
	588	4	592	163
TOTAL COST OF CONSTRUCTION IN PROGRESS	6,684	126	6,810	3,069

Estates Development

Expenditure incurred to 31 December 1983 is principally in respect of the following:–

Developments for re-sale:	Luk Yeung Sun Chuen — remaining flats
	Sun Kwai Hing Gardens
	Sun Kwai Fong Gardens

Under the terms of agreements entered into by the Corporation, the costs of constructing the buildings in connection with developments for re-sale are mainly borne by developers in consideration for a share in the sales proceeds.

Land relates to premia paid and payable to the Government.

8. CURRENT ASSETS

	Consolidated		The Corporation	
	1982 $M	1983 $M	1982 $M	1983 $M
Debtors and payments in advance	470	811	467	808
Stores and spares	84	84	84	84
Vested materials	2	52	2	52
Contract downpayments	3	22	3	22
Deposits and advances	7	9	7	9
Bank balances and cash in hand	6	5	6	5
	572	983	569	980

Vested Materials

Certain contracts contain clauses which allow materials to be purchased in advance of requirements and to be formally vested in the Corporation. The materials are valued at cost and will be fully incorporated into the main contract costs prior to completion of the relevant contracts.

9. CURRENT LIABILITIES

	Consolidated		The Corporation	
	1982 $M	1983 $M	1982 $M	1983 $M
Provision for railway construction cost on completed contracts	225	98	225	98
Creditors and accrued charges	979	1,676	973	1,667
Contract retentions	292	440	292	440
Bank overdrafts and short-term loans	1,028	1,239	1,028	1,617
Loan repayments due within 1 year	708	1,239	708	1,239
Amount due to MTR (Estates Management) Ltd.	—	—	38	65
6-3/8% registered notes due 1983	207	—	207	—
	3,439	5,070	3,471	5,126

10. SHARE CAPITAL

During the year the Corporation issued a further 145 shares of $100,000 each at par for cash to the Colonial Treasurer Incorporated (the corporate body empowered to hold securities for the Government) to provide finance for payment of rates.

11. LOANS

	Total Facilities Available 1983 $M	Undrawn Facilities 1983 $M	Total Loans Outstanding 1983 $M	1982 $M
LOANS				
Wholly repayable within 5 years	6,588	1,484	5,104	2,970
Not wholly repayable within 5 years	12,810	6,446	6,364	4,933
	19,398	7,930	11,468	7,903
Exchange translation differences			869	485
			12,337	8,388
Less: Loan repayments due within 1 year			1,239	708
TOTAL LOANS			11,098	7,680
CURRENT LIABILITIES				
Bank overdrafts and short-term loans	3,645	2,028	1,617	1,028
Loan repayments due within 1 year	—	—	1,239	708
6-3/8% registered notes due 1983	—	—	—	207
	23,043	9,958	13,954	9,623
Guaranteed loans	7,624	2,128	5,496	4,133
Unguaranteed loans and overdrafts	15,419	7,830	7,589	4,798
Total loans and overdrafts	23,043	9,958	13,085	8,931
Exchange translation differences			869	485
Guaranteed notes			—	207
			13,954	9,623

The guarantees on the loans described above have been given by the Government of Hong Kong.

TOTAL FACILITIES AVAILABLE

Total facilities available comprise two main elements -contract finance and general finance.

CONTRACT FINANCE

Contract finance comprises export credit facilities, foreign currency loans or facilities and Hong Kong dollar denominated deferred credit in respect of specific contracts amounting to approximately $8,001 million (1982 $8,362 million) and which are available to the Corporation in respect of contracts for the Modified Initial System, Tsuen Wan Extension and the Island Line. Of these facilities, approximately $7,698 million (1982 $7,994 million) are at fixed interest rates of between 7% and 9-1/4% per annum with the balance being at variable rates of interest. The final maturity of these facilities is between 1985 and 1995.

GENERAL FINANCE	1982 US $M	1982 HK $M	1983 US $M	1983 HK $M
General finance comprises:–				
Hong Kong Dollar bank overdrafts, short-term and medium-term facilities maturing within 5 years		5,939		8,054
US Dollar short-term and medium-term facilities maturing within 5 years	355	1,934	359	2,088
Hong Kong Dollar facilities maturing in 1988		1,400		4,900
		9,273		15,042

12. FOREIGN EXCHANGE COMMITMENTS

The Corporation has entered into agreements for the forward purchase of foreign currencies summarised as follows:

	1982		1983	
	Amount in Foreign Currency (in Million)	HK dollar equivalent per forward contracts $M	Amount in Foreign Currency (in Million)	HK dollar equivalent per forward contracts $M
Pound Sterling	1.00	10.60	4.00	39.48
Swedish Krona	43.75	43.75	37.92	37.92
French Franc	63.35	55.20	54.90	48.15
Japanese Yen	2,782.38	79.00	2,179.24	62.30

The above forward contracts have maturity dates varying from 1984 to 1990 and will be utilised to discharge loan repayments arising during these years.

13. DEPOSITS AND ADVANCES RECEIVED

Deposits and advances received are in respect of development properties.

14. DEFERRED LIABILITIES

	Consolidated	
	1982 $M	1983 $M
Refundable deposits on properties managed	7	10
Service charge and air-conditioning operating accounts	14	16
Building maintenance funds and asset replacement reserves	19	39
	40	65

15. CAPITAL COMMITMENTS

	1982 $M	1983 $M
Total authorised expenditure for the Island Line construction (excluding interest and finance costs)	10,900	10,900
Capital commitments not provided for in the accounts in respect of contracts entered into at 31 December	6,772	4,000

16. CONTINGENT LIABILITIES

There are contingent liabilities at 31 December 1983 in respect of amounts payable by the Corporation under Section 17 of the Mass Transit Railway Corporation Ordinance 1975 in respect of compensation paid by the Government pursuant to Section 18 of the Mass Transit Railway (Land Resumption and Related Provisions) Ordinance 1974 relating to railway construction. It is not possible to quantify the contingent liabilities at this stage, but, at 31 December 1983 Government had paid $9 million under the advance payment scheme for the Island Line construction.

17. PENDING LITIGATION

There is no pending litigation at 31 December 1983 that may have any significant adverse effect on the accounts of the Corporation.

18. SUBSIDIARY COMPANIES

	The Corporation	
	1982	1983
Unquoted shares, at cost	$1,000	$3,000

Details of subsidiary companies at 31 December 1983 are as follows:-

Name of company	Country of Incorporation	Effective holding (Ordinary Shares)%
MTR (Estates Management) Ltd.	Hong Kong	100
MTR Buses Ltd.	Hong Kong	100
MTR Engineering Services Ltd.	Hong Kong	100

ARRANGEMENTS FOR OFFER FOR SALE

Pursuant to the Purchase Agreement, the Managers have agreed, subject to the terms and conditions thereof, to offer the BPCs for sale by tender on the terms set out therein. To the extent that the BPCs are not taken up as a result of such tenders, the Managers have undertaken to purchase the BPCs at the Minimum Tender Price of 99.25 per cent. of their principal amount. MTRC will pay the Managers an underwriting commission of 0.15 per cent of the principal amount of the BPCs and will reimburse the Tender Agent for its expenses. Each Manager will also be invited to submit tenders upon the same terms applicable to all other tenderers. The Purchase Agreement entitles the Managers to terminate the Purchase Agreement in certain circumstances prior to payment of the Advance to MTRC.

The Tender Agent is inviting, on behalf of the Managers, certain institutions to tender competitive bids for the BPCs. Tendered bids will be accepted no later than 7 September 1984.

SELLING RESTRICTIONS

1. The BPCs have not been and will not be registered under the United States Securities Act of 1933 (the "Securities Act"). Accordingly, except as mentioned below, the BPCs may not be offered, sold or delivered, directly or indirectly, in the United States, its territories or possessions ("United States"), or to any national or resident thereof, including any corporation, partnership or other entity created or organized in or under the laws of the United States or any political subdivision thereof ("U.S. persons").

2. Each Manager and tenderer represents that it has not offered or sold, and has agreed that it will not offer, sell or deliver at any time, directly or indirectly, in the United States or to or for the account of any U.S. Person any BPCs acquired in connection with the distribution contemplated hereby, except for offers or sales to United States Managers or tenderers. In addition, each Manager and tenderer agrees that, prior to 90 days after the Closing Date, it will not, directly or indirectly, offer, sell or deliver in the United States or to or for the account of any U.S. Person any BPCs, no matter how acquired. Each Manager or tenderer further agrees that it will send to any dealer who purchases from such Manager or tenderer any of the BPCs acquired by it in connection with the distribution of the BPCs a notice stating in substance that the BPCs have not been registered under the Securities Act and that, by purchasing such BPCs, such dealer represents and agrees (i) that it has not offered or sold, and will not offer, sell or deliver at any time, any of such BPCs, directly or indirectly, in the United States or to or for the account of any U.S. Person, and that prior to 90 days after the Closing Date it will not offer, sell or deliver, directly or indirectly, in the United States or to or for the account of any U.S. Person any BPCs no matter how acquired and (ii) that it will deliver to any other dealer to whom it sells any of such BPCs a notice containing substantially the same statement as is contained in this sentence.

3. Notwithstanding the foregoing, with the prior written approval of Morgan Guaranty Ltd and in certain conditions, Managers and tenderers may offer or sell a portion of the BPCs to branches of United States Banks located outside the United States ("U.S. Bank Branch") provided that each such U.S. Bank Branch which purchases any such BPCs respresents and agrees in a certificate addressed to Morgan Guaranty Ltd and delivered to Morgan Guaranty Ltd prior to such purchase, that it is purchasing such BPCs for its own account for investment and without a view to any distribution or other disposition of such BPCs and that, in the event of any disposition of any such BPCs (such disposition not being foreseen or contemplated at the time of delivering such certificate) it will not offer, sell or deliver any such BPCs directly or indirectly except in compliance with the Securities Act.

4. As a condition to the acceptance of your tender in accordance with the above, you hereby represent that you have not offered or sold, and agree that you will not offer, sell or deliver at any time, directly or indirectly, in the United States (which term, as used herein, includes its territories and possessions) or to or for the account of any national or resident thereof (including the estate of any such person and any corporation or other entity organized under the laws thereof or any political subdivision thereof) (a "U.S. person") any BPCs acquired in connection with the distribution contemplated hereby, except for offers for sales to United States Managers or tenderers. In addition you agree that, prior to 90 days after the Closing Date (as defined herein), you will not, directly or indirectly, offer, sell or deliver in the United States or to or for the account of any U.S. Person any BPCs no matter how acquired. Notwithstanding the foregoing, with the prior written approval of Morgan Guaranty Ltd, BPCs may be offered to branches of United States banks located outside the United States ("U.S. Bank Branch"); provided that each such U.S. Bank Branch which purchases any BPCs represents and agrees, in a certificate addressed to Morgan Guaranty Ltd and delivered to Morgan Guaranty Ltd prior to such purchase, that, inter alia, it is purchasing such BPCs for its own account for investment and without a view to any distribution or other disposition thereof and that, in the event of any disposition of any BPCs (such disposition not being foreseen or contemplated at the time such certificate is delivered), it will not offer, sell or deliver any such BPCs directly or indirectly except in compliance with the United States Securities Act of 1933. You further agree that you will send to any dealer who purchases from you any of the BPCs acquired by you in connection with the distribution of the BPCs a notice stating in substance that the BPCs have not been registered under the United States Securities Act of 1933 and that, by purchasing such BPCs, such dealer represents and agrees (i) that it has not offered or sold, and will not offer, sell or deliver at any time, any of such BPCs, directly or indirectly, in the United States or to or for the account of

any U.S. Person, and that prior to 90 days after the Closing Date it will not offer, sell or deliver, directly or indirectly, in the United States or to or for the account of any U.S. Person any BPCs no matter how acquired and (ii) that it will deliver to any other dealer to whom it sells any of such BPCs a notice containing substantially the same statement as is contained in this sentence.

5. Notwithstanding the above, offers or sales of BPCs may be made to persons outside the United States who are not U.S. persons through United States agents or fiduciaries, provided that such agents or custodians confirm in writing that they are acting pursuant to specific instructions from their principal or beneficiary and without discretionary authority for the benefit of such persons and that the investment decision relating to such offers or sales was made outside the United States.

6. Unless a purchaser is so permitted under the securities laws of the United Kingdom, no purchaser may distribute or cause to be distributed, in or from the United Kingdom, the Information Memorandum or any other offering material relating to the BPCs except to persons whose ordinary business involves the acquisition and disposal, or the holding, of securities whether as principal or agent.

7. Each purchaser of BPCs must comply with all applicable laws and regulations in each jurisdiction in which it purchases, offers, sells or delivers BPCs or in which it was in its possession or distributes the Information Memorandum or any other offering material. No purchaser is authorised to make any representation or use any information in connection with the issue, subscription and sale of the BPCs other than as contained in the Information Memorandum.

HONG KONG TAXATION

All payments of interest on the Coupons will be paid subject to deduction of Hong Kong interest tax unless appropriate evidence and indemnification can be produced, if requested, to justify payment without such deduction (see "The Intermediary Agreement and the BPCs — Taxation"). The most common cases of payment without deduction are likely to be where the holder shows that it is a licensed bank or a corporation carrying on trade or business in Hong Kong. In such a case, the relevant interest will usually form part of the holder's income for Hong Kong profits tax purposes.

Purchasers or intending purchasers who are in any doubt as to their own tax position are recommended to consult their advisers.

GENERAL INFORMATION

1. The entering into of the Intermediary Agreement by MTRC was authorised pursuant to a resolution of its Board of Directors passed on 3 September 1984.

2. The legal notice relating to the issue of the BPCs and the Mass Transit Railway Corporation Ordinance have been lodged with the Registrar of the District Court in Luxembourg ("Greffier en Chef du Tribunal d'Arrondissement de et a Luxembourg"), where such documents may be examined and copies obtained.

3. All necessary governmental consents in Hong Kong for the transactions contemplated in this Information Memorandum have been obtained.

4. There has been no material adverse change in the financial position of MTRC since 31st December, 1983.

5. MTRC is not involved in any litigation, arbitration or administrative proceedings of material importance in the context of the issue of the BPCs nor, so far as it is aware, are any such proceedings pending or threatened.

6. Messrs. Peat, Marwick, Mitchell & Co. have given and have not withdrawn their written consent to the issue of this Information Memorandum with the inclusion herein of their report dated 3 September 1984 in the form and context in which it is included.

7. So long as any of the BPCs remains outstanding, copies of the Mass Transit Railway Corporation Ordinance and the latest audited financial statements of MTRC together with copies of the Intermediary Agreement, Reference Agent Agreement and Paying Agency Agreement will be available at the specified offices for the time being of the Paying Agents.

8. The BPCs have been accepted for clearance through Euro-clear (reference No. 10361) and CEDEL S.A. (reference No. 292150). Any person depositing BPC's with Euroclear or CEDEL will be required, if he wishes to receive payment of interest gross (and is entitled to do so), to authorize Euroclear or CEDEL, as the case may be, to release to any paying agent any evidence and/or indemnity that such holder is, or is not, exempt from Hong Kong interest tax.

Mass Transit Railway Corporation
MTRC Headquarters
33 Wai Yip Street
Kowloon Bay
Hong Kong

INTERMEDIARY

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Queensway House
Queen Street
St. Helier, Jersey
Channel Islands

TENDER AGENT

Morgan Guaranty Trust Company of New York
Edinburgh Tower, 23rd Floor
Landmark, 15 Queen's Road Central
Hong Kong

PAYING AGENTS

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Hong Kong

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